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TAXATION OF EMPLOYEE BENEFITS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

TAXATION OF EMPLOYEE BENEFITS

CHICAGO, IL—JUNE 10, 1985

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HEARING DATE

June 10, 1985:
Morning session 1

TAXATION OF EMPLOYEE BENEFITS

MONDAY, JUNE 10, 1985

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 9:15 a.m., in room 2525, Everett M. Dirksen Federal Building, 219 South Dearborn Street, Chicago, IL, Hon. Alan J. Dixon (acting chairman of the committee) presiding.

Present: Senator Dixon.

Staff present: Karyl McCurdy Arnold, legislative assistant to Senator Dixon, Tom Walsh, tax counsel, and Stewart J. Hudson, professional staff member.

STATEMENT OF HON. ALAN J. DIXON, A U.S. SENATOR FROM THE STATE OF ILLINOIS AND ACTING CHAIRMAN OF THE COMMITTEE ON SMALL BUSINESS

Senator DIXON [acting chairman]. Good morning.

Ladies and gentlemen, I would like to begin this morning by welcoming our distinguished group of witnesses and thanking them for taking valuable time off from their busy schedules to be here with us today.

This hearing is one of a series of field hearings conducted by the Senate Small Business Committee exploring the impact of the various tax simplification proposals upon small business.

On March 4, 1985, I held a hearing in Chicago on the alternative tax reform plan then before the Congress. Today we are here to assess the effect of the administration's proposal to tax employee benefits upon small business. The initial Treasury proposal would have increased the taxation of many employer-provided fringe benefits. The revised Treasury proposal, which we call Treasury II, would modify the tax treatment of fringe benefits and would increase the taxation of certain fringe benefits.

First, Treasury II would not tax certain planned benefits if the plans are nondiscriminatory and are offered to all employees of a firm rather than to a select few.

Second, the revised proposal would tax as ordinary income up to $10 a month for individual coverage of an employee under health plans and up to $25 a month for family coverage.

Finally, Treasury II would fully tax death benefits provided by employers and eliminate the tax-free treatment of the first $5,000 of such benefits.

I must admit that I approach this hearing with a healthy skepticism over the wisdom of taxing employee benefits. I have long be-

lieved that the special tax treatment afforded employee benefits has been essential in implementing critical social goals and has created excellent health care and pension plans; 80 percent of new employment in Illinois still comes from small businesses. Even though small businesses are the principal job-creating sector of the economy during recessions and expansions, small businesses are likely to offer fewer and less comprehensive fringe benefits than larger businesses.

The principal factor that determines whether a small employer offers pension or health benefits is profitability. As a result of their lower profit margin, small businesses are less able than large businesses to afford the costly premiums necessary to maintain benefits.

Administrative costs are relatively fixed, requiring the same time and expense to establish a plan for 5 as for 50 employees. Any changes in the taxation of employee benefits must be seriously reviewed in terms of its impact upon small businesses.

Fringe benefits available in small firms are critical in hiring and retaining productive workers and competing with large firms. Increasingly complex Federal rules and regulations have increased the cost of benefit programs, an increase which is felt disproportionately by small businesses.

For example, as a result of ERISA in 1974, the average administrative cost of small plans with fewer than 100 participants increased 72 percent. The high cost of providing certain benefits also affects the extent of employee benefit coverage in small firms. For example, rising health care costs present a significant impediment to the expansion of health insurance benefits in small firms.

The purpose of today's hearing is to develop a record which documents the effect of the proposal to tax employee benefits upon small business before any legislation is enacted. I am looking forward to hearing from our witnesses, and I am honored to call as our first witness an old friend, Mr. Eugene Moats, the international vice president of the Service Employees International Union and the president of the Service Employees International Union here in Illinois. Of course, Mr. Moats is from Chicago.

Good morning to you, Gene. It is nice to see you.

STATEMENT OF EUGENE P. MOATS, INTERNATIONAL VICE PRESIDENT OF SERVICE EMPLOYEES INTERNATIONAL UNION AND PRESIDENT OF SERVICE EMPLOYEES INTERNATIONAL UNION OF ILLINOIS

Mr. MOATS. Good morning, sir.

Senator DIXON. You may proceed.

Mr. MOATS. Thank you, Senator.

I want to thank the members of the panel for accommodating me.

As you have described me, I am the vice president of the Service Employees International Union in this area and president of a 100,000 member group within the State of Illinois representing building service and even many health care workers.

On behalf of our international president, John Sweeney, and the 850,000 members of SEIU, I want to thank Senator Weicker, chair-

man of the Senate Committee on Small Business, and you, Senator Dixon, for inviting us to share our views on the simple tax proposals.

This committee certainly recognizes the importance of genuine tax reform to small business. Many of our largest and most profitable companies—General Electric, W.R. Grace, General Dynamics, Dow Chemical—pay little or nothing on billions of dollars in profits. Closing the tax loopholes would put small businesses on a more even footing with big corporations that now benefit from a wide array of tax breaks. If big corporations paid their fair share, the tax burden on small business could be reduced.

Workers would also clearly benefit from any improvement in the competitive position of small firms. According to a recent Dun & Bradstreet survey, small business is expected to provide about 80 percent of the new job openings this year.

At the outset let me emphasize that our union has long been an advocate of comprehensive Federal tax reform. We are pleased that the President and many Members of Congress from both parties now recognize that our loophole-ridden tax system has become grossly unfair and requires a major overhaul.

President Reagan's recently announced reform proposals contain many laudable features but fall disappointingly short of the comprehensive reform America's taxpayers need and want.

SEIU strongly supports increases in the personal exemption, the zero-tax-bracket amount, and the earned income tax credit. Together such proposals will remove the burden of Federal income taxes from working Americans below the poverty line and make the tax system fairer for millions of moderate- and low-income Americans.

At the same time a number of proposals in the President's plan undermine the prospects for fair tax reform. In particular, our union strongly opposes the taxation of health care benefits as unfair—unfair to America's workers who have always paid full taxes on their wages.

The President says there are strong equity arguments in favor of taxation of fringe benefits—claims of tax-free health benefits providing subsidies to high-wage workers and unfairly penalizing workers who must purchase an individual health policy. There is also a claim that they encourage excessive consumption of medical care and contribute to the erosion of the tax base and the deficits.

The administration's position, however, in the debate over fringe benefits tax policy does not square with the facts. In reality, the President's new health tax on the first $10 per month of individual's health premiums and the first $25 for family is both inequitable and will contribute to runaway deficits in the future. Frankly, it is also poor health policy.

Health care is not a rich man's benefit. The President's plan will require 90 percent of American workers to pay new income taxes on about 19 percent of their health benefits. Nearly 80 percent of these workers covered by health insurance plans earn less than $25,000 per year. A long struggle our low-income members have engaged in at the bargaining table to win health care insurance coverage would be severely eroded if such a tax was imposed.

The administration paints this plan as less onerous than the earlier Treasury proposal, Treasury I. In that plan workers paid taxes

on all employer-paid family health premiums above a cap of $175 per month and above $70 per month for individual premiums. It is true that the President's new plan raises only about half of the $34 billion in total revenues projected over 5 years under the Treasury I plan. However, despite the reduced price tag of the administration's new approach, it suffers from all of the defects of the original plan. The new floor is no better than the old cap. To the contrary, it is a totally regressive tax shift which hits hardest on low- and middle-income working people.

The real inequities become clear when you look at an example of the local union which I am privileged to head, Local 25 of the Service Employees Union. My union represents about 13,000 workers, mostly in traditionally low-paying jobs —cleaning, maintenance, elevator, and security jobs in the downtown office buildings where we are located right now. About 65 percent are women, and many are immigrants who have fought against heavy odds to better their lives and to increase the opportunities for their children.

Over the years we have worked hard to achieve decent wages and to improve the health and well-being of our members. Health care benefits were a real struggle because many of our employers are small businesses. The average number of covered employees per contract is 26, and only 8 for security guard agencies, who cannot afford to provide Cadillac benefits. But in concert with employers, we managed to come up with an innovative way to pool our health resources and to provide comprehensive health care at low cost.

The solution was the local 25 welfare fund. I am the chairman of the board and a trustee of that fund. It is a jointly administered fund in which the Building Managers Association of Chicago names members and local 25 names members.

The fund supports a health maintenance organization, a free-standing outpatient hospital which provides dental care, medical care, and we also provide a fee-for-service plan or indemnity plan.

Operationally, this welfare fund and the HMO which it owns and operates is a small business itself employing close to 130 workers and about 50 physicians, most of whom work part time on the staff of the health maintenance organization.

The medical plan provides full coverage health care including all physician visits and routine eye and dental care to about 8,500 participants. The cost to employers is 80 cents hourly or about $128 over 4 weeks. The composite rate for union health services comes to $57.93 monthly. Full hospitalization paid directly by the fund roughly doubles these health costs.

As a result, local 25 would have been under the $175 cap. Now our members will pay taxes on an additional $120 to $300 a year under this proposal. The Reagan plan will cost our workers who earn $12,000 to $15,000 a year about $100 in new Federal and payroll taxes.

On balance, this new proposal is worse for SEIU low-income members than even the original Treasury proposal. For example, the $175-a-month family cap would not have touched most of our local 32B-32J's 65,000 members in New York City because plan costs average only $130 to $140 per month, but they would pay now under this plan.

It would also affect our Texas nursing home workers who recently fought for health coverage in their first union contract.

In short, the President's new plan goes a giant step further in shifting tax burdens onto the backs of low- and middle-income working people.

Let me empnasize that we also strongly reject any plan to tax health benefits. Even under Treasury I, about half of all SEIU members would be hurt, mostly because they live in high-cost regions. For example, the State of California pays $211 per family for health benefits. California Blue Cross premiums average about $250 monthly for family coverage.

The importance of these fluctuations in medical costs by region is underscored by looking at the range of premiums paid for the same benefits in different geographic areas. Contribution rates for family coverage in Service Employee's national health and welfare fund range between $117 to $201 monthly. The high-cost areas include California, Illinois, Michigan, New York, Ohio, and Pennsylvania. The low-cost areas are principally in the South.

As a union which represents many low-wage working men and women, any tax increase affecting our members causes us concern. Increases in Federal taxes at this time are especially unfair since low-income working people have already been forced to grapple with cutbacks in public services over the last 4 years, during which Federal tax reduction efforts have channeled billions of dollars to the very wealthy in our society and to the corporate sector.

In addition to increased tax burdens for American workers, there are plenty of other reasons to oppose Reagan's health tax plan. First, the income base on which payroll taxes are calculated would rise forcing businesses to either find more money or cut services. Small businesses would be especially hard pressed by this added bias in the tax system against labor because most small firms are labor intensive and operate at low-profit margins. They would most likely pass these tax increases back to workers in lower wages or else reduced health benefits.

Preventive care, diagnostic service, prescription drugs, eye and dental care are likely targets for the knife. Our low-income members would find it difficult to pay the extra money required to maintain these benefits. With the reduction in health services and the rising cost of health care we already experience, the ability of low-income people to have access to health services would be severely impaired.

Second, taxing employer-provided health care would jeopardize our national policy of encouraging essential health care. Neutrality is the general principle of tax reform, but even tax purists accept the Tax Code as a way to promote desirable social objectives. On principle, proposals to tax employer-paid health insurance are much more disturbing to us than even a general tax increase. We believe that the taxation of health benefits would act as a disincentive to the provision of health insurance in the future and, as a result, would severely impair the ability of working people and their families to achieve and maintain access to quality health care.

At a time when the health coverage of Americans is being reduced for the first time in 20 years, the administration's proposal

would create a major new impediment to grow in future years, exacerbating the problem of a dual class health system.

Do we really want to return to a 19th century health policy as we approach the 21st century? Nor will the President's plan control medical costs. Declining quality of care, especially preventive health care, could raise future deficits leading to more hospitalization and forcing people into the Medicaid roles.

According to the Senate Finance Committee, the Federal Government would have to spend about $100 billion more to provide the same services that the private sector now provides with about $30 billion a year in tax subsidies.

Senator, I make some additional comments about the administration's plan—the deductability of local taxes, and also the taxation of unemployment insurance, and workers' compensation to which we are completely opposed. But, in the interest of time and the fact that you wanted us to keep our testimony to a reasonable time, we will give you copies, of course, of the testimony.

However, I would like to just summarize by specifically urging this committee and the Congress to adopt the following changes in the President's proposals:

We ask that you drop provisions of taxing employer-paid health insurance, workers' compensation, and unemployment insurance; drop the provision denying deductions of State and local taxes; adopt a depreciation system based on the real economic lives of plant and equipment, as in the original Treasury bill; and close other special-interest loopholes; and adopt maximum tax rates for wealthy individuals and corporations of 40 percent.

We know that a tax, is a tax, is a tax. This is a tax, a new tax, that is being proposed to place on the backs of those in our society least able to afford it. As I said before, our membership represents many women who are heads of households struggling to raise families. They cannot afford to pick up the tab for the wealthy, high-income individuals and the corporations. We would ask this committee, we hope, to look at that aspect of this, and we hope that you will report out unfavorably on these kinds of proposals and find other sources of revenue that are more fair and equitable.

Senator DIXON. Gene, I thank you very much for your testimony. Of course, the entire remarks that you have presented here will be reproduced in the record in full as though read in full. I thank you for that.

I was intrigued by the point that you have made, I think very eloquently, in your statement about the fact that many ways Treasury I for the low-income people that you represent was preferable——

Mr. MOATS. Yes.

Senator DIXON [continuing]. With a tax cap above the level of benefits that they receive to Treasury II which has a limited tax as a substitute for it. Even though there is a reduction, I think of fully 50 percent, in the amount of revenue loss—or revenue recovery—by the tax plan, in fact it actually hurts your low-income workers more under Treasury II than it would under Treasury I.

Mr. MOATS. That is correct.

Senator DIXON. I think that is a very interesting point.

I might say to you that not only am I noting by these statements in the record, but at the first opportunity I do want to share with our friend and associate from this State, Congressman Rostenkowski, who will chair those hearings in the House Ways and Means Committee, that point that you make. Of course, it is not to say that ultimately there will be some kind of tax on fringe benefits. I think I made it clear in my initial remarks that I personally do not support that concept. But should that be a matter that would be under consideration ultimately, I get the point that at least for folks like those you represent that a higher cap is preferable to a minimum tax, because it excludes those low-income people that you generally represent. I think that is a matter that Congress ought to be concerned about.

Mr. MOATS. Yes, sir.

Senator DIXON. Have your people done any kind of research, Gene, on the question of what kind of a net result it would be to your folks by the simplification of tax reform so far as the amount of money that they would gain by the tax simplification vis-a-vis the amount of money they would lose by taxing those fringe benefits?

Mr. MOATS. Yes, we have. We find a net loss again for low-income people. As an example, we took someone making $14,000 a year. We added in the benefits from the bracketing, the tax-reduction revenue enhancement part of the—revenue-reduction part of the program—and added on the health benefits cost, the additional cost to the worker, and we found that it would be somewhere in the range of $100 additional taxes as a net result of the overall program.

Senator DIXON. So you are saying that one of your employees earning $14,000 a year, notwithstanding tax simplification, when you add in the taxes paid on fringe benefits would actually pay additional taxes of $100 a year?

Mr. MOATS. Yes, sir; that is correct. That is why we think that Treasury II is even more onerous than Treasury I.

Senator DIXON. Well, I appreciate very much your remarks. I also understand the necessity of your going along to another obligation this morning.

I want to thank those in the original panel for permitting you to go ahead, Gene. Your contribution here is greatly appreciated.

I think one of the things we want to note as we discuss tax simplification is that it might be simplified, but for some of the lower earners in the country it may, in fact, be a hidden tax increase.

Mr. MOATS. It certainly is, and when you meet with Congressman Rostenkowski, you might mention that many of the people that I talked about today, the little Polish cleaning ladies in these buildings, are his constituents as well as mine.

Senator DIXON. I know you touch his heart when you mention their ethnic origin. [Laughter.]

Mr. MOATS. Thank you, Senator.

Senator DIXON. Thank you, Gene. Have a good trip.

[The prepared statement of Mr. Moats follows:]

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JOHN J. SWEENEY
INTERNATIONAL PRESIDENT

RICHARD W. CORDTZ
INTERNATIONAL SECRETARY-TREASURER

TESTIMONY OF THE

SERVICE EMPLOYEES INTERNATIONAL UNION, AFL-CIO, CLC

BEFORE

THE HONORABLE ALAN J. DIXON

COMMITTEE ON SMALL BUSINESS
UNITED STATE SENATE

Taxation of Employee Benefits

June 10, 1985

SUBMITTED BY:

Eugene P. Moats
International Vice President
Service Employees International Union, AFL-CIO, CLC
Chicago, Illinois

STATEMENT OF EUGENE P. MOATS, INTERNATIONAL VICE PRESIDENT

SERVICE EMPLOYEES INTERNATIONAL UNION, AFL-CIO, CLC

I am Eugene P. Moats, International Vice President of the Service Employees International Union, and President of SEIU Local 25 which represents nearly 13,000 building service and health care workers in the Chicago area.

On behalf of our International President John Sweeney and the 850,000 members of SEIU, I want to thank Senator Weicker, Chair of the Senate Committee on Small Business, and Senator Alan Dixon of Illinois for inviting us today to share our views on the "simple tax" proposals.

This Committee certainly recognizes the importance of genuine tax reform to small business. Many of our largest and most profitable companies -- General Electric, W.R. Grace, General Dynamics, Dow Chemicals -- pay little or nothing on billions of dollars in profits. Closing the tax loopholes would put small businesses on a more even footing with big corporations that now benefit from a wide array of tax breaks. If big corporations paid their fair share, the tax burden on small business could be reduced. Workers would also clearly benefit from any improvement in the competitive position of small firms. According to a recent Dunn and Bradstreet survey, small business is expected to provide about 80% of the new job openings this year.

At the outset, let me emphasize that SEIU has long been an advocate of comprehensive federal tax reform. We are pleased that the President and many members of Congress from both parties now recognize that our loophole-ridden tax system has become grossly unfair and requires a major overhaul.

President Reagan's recently announced reform proposal contains many laudible features but falls disappointingly short of the comprehensive

reform America's taxpayers demand.

SEIU strongly supports increases in the personal exemption, the zero bracket amount, and the earned income tax credit. Together, such proposals will remove the burden of federal income taxes from working Americans below the poverty line and make the tax system fairer for millions of moderate and low income Americans.

At the same time, a number of proposals in the President's plan undermine the prospects for fair tax reform. In particular, SEIU strongly opposes the taxation of health care benefits as "unfair". "Unfair" to America's workers who have always paid full taxes on their wages.

The President says that there are strong equity arguments in favor of taxation of fringe benefits. There are numerous claims... Tax-free health benefits provide subsidies to high wage workers and unfairly penalize workers who must purchase individual health policies. They also encourage excessive consumption of medical care. Finally, they contribute to the erosion of the tax base and soaring deficits.

However, the Administration's position in the debate over fringe benefit tax policy does not square with the facts. In reality, the President's new health tax -- on the first $10 per month of individuals' health premiums and the first $25 for families -- is both inequitable and will contribute to runaway deficits in the future. And frankly, it's also poor health policy.

Health care is not a rich man's benefit. The President's plan will require 90% of American workers to pay new income taxes on about 19% of their health benefits. Nearly 80% of these workers covered by health insurance plans earn less than $25,000. The long struggles our low-income members have engaged in at the bargaining table to win health insurance coverage would be severely eroded if such a tax was imposed.

The Administration paints this plan as "less onerous" than the earlier Treasury Proposal. In that plan, workers paid taxes on all employer paid family health premiums above a "cap" of $175 per month and above $70 per month for individual premiums. It's true that the President's new plan raises only about half the $34 billion in total revenues projected over 5 years under the Treasury I plan. However, despite the reduced price tag of the Administration's new approach, it suffers from all the defects of the original plan. The "new floor" is no better than the "old cap". To the contrary, it is a totally regressive tax shift which hits hardest on low and middle income working people.

The real inequities become crystal clear when you look at my local. Local 25 represents about 13,000 workers mostly in traditionally low-paying jobs -- cleaning and maintenance, security guards, and food service. About 65 percent are women and many are immigrants who have fought against heavy odds to better their lives and to increase the "opportunities" for their children. Over the years, we have worked hard to achieve decent wages and to improve the health and well-being of our members. Health care benefits were a real struggle because many of our employers are small businesses -- the average number of covered employees per contract is 26 and only 8 for security guard agencies -- who can not afford to provide "cadillac" benefits. But in concert with employers, we managed to come up with an innovative way to pool our health resources and to provide comprehensive health care at low cost.

The solution was the Local 25 SEIU Welfare Fund. I am the Chairman of the Board and a trustee. The Fund supports a health maintenance organization, a dental care center and a fee-for-service plan. Operationally, it is a small business -- employing close to 130 workers. The medical plan provides full coverage health care, including all physician

visits and routine eye and dental care, to about 8,500 participants. The cost to employers is $.80 hourly or about $128 over four weeks. The composite rate for union health services comes to $57.93 monthly. Full hospitalization paid directly by the fund roughly doubles these health costs.

As a result, Local 25 would have been under the $175 "cap". Now, our members will pay taxes on an additional $120 to $300 a year. The Reagan plan will cost our workers who earn $12,000 - $15,000 a year about $100 in new federal and payroll taxes.

On balance, this new proposal is worse for SEIU low income members than even the original Treasury proposal. For example, the $175 a month family "cap" would not have touched most of Local 32B-32J's 65,000 members in New York, because plan costs averaged only $130 - $140 per month. But they will pay now. It will also affect our Texas nursing home workers who recently fought for health coverage in their first union contract. In short, the President's new plan goes a giant step further in shifting tax burdens onto the backs of low and middle income working people.

Let me emphasize that we also strongly reject any plan to tax health benefits. Even under Treasury I, about half of all SEIU members would be hurt, mostly because they live in high cost regions. For example, the state of California pays $211 per family for health benefits. California Blue Cross premiums average about $250 monthly for family coverage.

The importance of these fluctuations in medical costs by region is underscored by looking at the range of premiums paid for the same benefits in different geographic areas. Contribution rates for family coverage in SEIU's national Health and Welfare Fund range between $117 - $201 monthly. The high cost areas include California, Illinois, Michigan, New York, Ohio and Pennsylvania. The low cost areas are mainly in the South.

As a union which represents many low-wage working men and women, any tax increase affecting our members causes us concern. Increases in federal taxes at this time are especially unfair, since low-income working people have already been forced to grapple with cutbacks in public services over the last four years, during which federal tax reduction efforts have channelled billions of dollars to the very wealthy in our society and to the corporate sector.

In addition to increased tax burdens for working Americans, there are plenty of other reasons to oppose Reagan's health tax. First, the income base on which payroll taxes are calculated would rise, forcing businesses to either find more money or cut services. Small business would be especially hard-pressed by this added bias in the tax system against labor because most small firms are labor intensive and operate at low profit margins. They would most likely pass these cost increases back to workers in lower wages or else reduce health benefits. Preventive care, diagnostic services, prescription drugs and eye and dental care are likely targets for the knife. Our low income members would find it difficult to pay the extra money required to maintain these benefits. With the reductions in health services and the rising cost of health care we have already experienced, the ability of low-income people to have access to health services would be severely impaired.

Second, taxing employer-provided health care would jeopardize our national policy of encouraging essential health care. Neutrality is a general principle of tax reform. But even tax purists accept the tax code as a way to promote desirable social objectives.

On principle, proposals to tax employer-paid health insurance are much more disturbing to us than even a general tax increase. We believe that taxation of health benefits would act as a disincentive to the provision of

health insurance in the future and, as a result, would severely impair the ability of working prople and their families to achieve and maintain access to quality health care.

At a time when the health coverage of Americans is being reduced for the first time in twenty years, the Administration's proposal would create a major new impediment to the goal of expanded coverage. Once in place, such an impediment would likely grow in future years, exacerbating the problem of a dual class health system. Do we really want a return to a 19th century health policy as we approach the 21st century?

Nor will the President's plan control medical costs. Declining quality of care, especially preventive health care, could raise future deficits -- leading to more hospitalization and forcing people onto the Medicaid rolls. According to the Senate Finance Committee, the federal government would have to spend about $100 billion more to provide the same services that the private sector now provides with about $30 billion a year in tax subsidies.

Still other proposals in the President's plan undermine the cause of genuine tax reform. For instance, repealing the deductibility of state and local taxes imposes a double tax and unfairly penalizes workers in high tax states.

SEIU also strongly opposes the taxation of unemployment insurance and workers' compensation. Under current law, unemployment benefits, which average only $119 per week nationwide, are already subject to taxation if income exceeds $12,000 for singles and $18,000 for married taxpayers. Workers' compensation benefits are already woefully inadequate to meet the day-to-day needs of disabled workers and their families. Why compound the misery of joblessness and disability by further taxing these meager benefits?

Is it fair to discriminate against workers in high medical cos

states? Is it fair to discriminate against workers in small business? Is it fair to discriminate against those who are struggling to escape from poverty? Is it fair to discriminate against workers in high cost states? These are the real "fairness" questions.

The President's proposals also fall way short of the major overhaul needed to end the unfair preferential treatment given oil and gas, stock and real estate speculators and banks. Also, the capital gains loophole is expanded and the new depreciation plan will eventually be more costly than the current accelerated depreciation scheme. The result is that over the long term, when temporary gimmicks in the plan have run their course, the Reagan program will achieve only a token 9% increase in corporate taxes. This is woefully inadequate. With corporate taxes accounting for only one-sixth of all income taxes under current law, it will not pay for a 7% cut in individual taxes. Even with optimistic assumptions about steady economic growth, the Reagan tax program is projected to lose $13 billion over 5 years. An economic downturn, even a small one, would create a "crisis" deficit of truly mammoth proportions.

SEIU believes we can do better. We urge Congress to embrace genuine reforms that redress the inequities of our current system, put the tax shelter industry out of business and restore the corporate tax to a fair share of federal revuenues.

Specifically, we urge Congress to adopt the following changes to the President's proposal:

(1) Drop provisions taxing employer paid health insurance, workers' compensation and unemployment insurance;

(2) Drop the provision denying deductions of state and local taxes;

(3) Adopt a depreciation system based on the real economic lives of plant and equipment as in the original Treasury plan, and close other

special interest loopholes; and

(4) Adopt maximum tax rates for wealthy individuals and corporations of 40%.

These major changes would provide greater tax cuts for low and moderate income Americans beyond those proposed by the President. In addition, this approach would raise sufficient money to close the federal deficit gap.

Such a truly comprehensive reform would promote fairness, restore taxpayer confidence, and encourage economic growth by forcing our companies to stop looking for tax shelters and go back to making money the old fashioned way - by earning it.

Senator DIXON. I would like to call Ralph Eckert, the chairman and chief executive officer of Benefit Trust Life Insurance Co. here in Chicago, and Prof. Robert Resek, the director of the Bureau of Economics and Business Research for the University of Illinois at Champaign.

Did I understand, Mr. Eckert, that you had a time problem? Was it you or the professor?

Mr. ECKERT. No. I have a time problem, but if I am out of here by 10:30, I am in great shape.

Senator DIXON. OK. Swell.

Then why don't you proceed, Mr. Eckert.

STATEMENT OF RALPH J. ECKERT, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BENEFIT TRUST LIFE INSURANCE CO., REPRESENTING THE HEALTH INSURANCE ASSOCIATION OF AMERICA AND THE AMERICAN COUNCIL OF LIFE INSURANCE

Mr. ECKERT. As you mentioned, Senator, I am chairman and chief executive officer of the Benefit Trust Life Insurance Co. located here in Chicago, but I am also the immediate past chairman of the Health Insurance Association of America. I am appearing here today on behalf of the Health Insurance Association of America and the American Council of Life Insurance.

The HIAA has 350 member companies who write over 85 percent of the health insurance written in the United States by insurance companies. The ACLI has 615 member life insurance companies who write about 95 percent of the life insurance written in the United States and hold 97 percent of the assets of insured pension plans. Many of the members of the ACLI also write health insurance.

Mr. Chairman, we are grateful that you and the members of your committee are holding hearings to look into the impact that the Treasury proposals would have on various industries and their customers.

Present tax policy has led to the greatest private voluntary system of life and health insurance this world has ever seen. It has come about through the development of a mechanism called group health insurance. Key to the development of employee group insur-

ance and essential to its continuation is a favorable tax climate that permitted its development.

First, what has it accomplished? Health insurance provided by employee benefit plans falls into two broad categories: benefit payments for hospital, medical, and dental expenses and income payments to disabled workers or disability insurance.

By the end of 1982, including spouses and children, approximately 162 million persons under the age 65 were covered by some form of group health insurance. A 1980 study of employees with insured major medical plans showed that three-fourths had a maximum benefit of no less than $250 million and nearly half would pay to $1 million or were unlimited.

Senator DIXON. You meant there $250,000, did you not, Mr. Eckert?

Mr. ECKERT. I'm sorry, $250,000.

Senator DIXON. You sound like the Congress—you're adding three zeroes all the time. [Laughter.]

Mr. ECKERT. Our own plan is unlimited.

Private industry innovation has not only brought dental care and vision care, but also cost-containment coverage for such things as skilled nursing homes, home health care, preadmission testing, ambulatory surgery, second opinions, preventive care, hospice care, and drug and alcohol rehabilitation. In all, in 1983 the cost of private group medical coverage was between $105 and $110 billion.

The pluralistic nature of the private health insurance business has resulted in intense competition among carriers. As a result, an insurer must keep its premiums as low as possible which provides both employees and employers with the most cost-effective protection possible.

The consumer interest is also protected through our system of State insurance regulations covering such areas as group policy and certificate provisions, group conversions, and so forth.

In fact, due to the flexible nature of the business, employees may continue to maintain medical expense protection upon termination of employment by either converting to an individual policy or continuing benefits under the group plan for various periods. In many instances coverage is also continued for a specified time for dependents who lose eligibility due to an employee's death or even sometimes divorce.

A particular relevant example of how the competitive insurance marketplace has served the public interest is the development of group insurance for small employers with as few as one or two employees. According to Department of Commerce data, there were 4.3 million firms with 1 to 49 employees in 1980. These small groups probably provide employment for over 15 million workers. To serve that market, insurers developed pooling techniques and simplified underwriting rules and, as a result, small employers today have a wide choice of plans.

The stimulus of tax incentives and the willingness of carriers to voluntarily enter the small group market have been of great benefit to the small employers and their employees and families. As a result, small firms can today obtain many coverages once only available to larger firms and can fully realize the advantages of the tax incentives of the law.

Overall, the encouragement of health insurance coverage through tax incentives has been enormously successful in terms of social and economic accomplishments. The present system of employment-related health benefits was built up over several decades and works very well. Americans have come to regard employer-sponsored health protection almost as an automatic feature of employment, providing benefits of great value. In our view, no change should be made in tax incentives which might impair the ability of the private sector to provide essential insurance protection to the public.

What the Government has done for the elderly with Medicare and for the poor with Medicaid, at a cost this committee well knows, the private sector has done for the bulk of working class America. And the key to that making it all possible is a favorable tax policy. Take it away and you place the whole mechanism in jeopardy. Here is why:

To make it work, you need to cover essentially all the employees in a group. Now the employer pays most or all of the premium, and the employee pays no tax. So almost everybody signs up. But increase the direct cost to the employee through taxes or otherwise, and they begin to drop out—the young, the healthy, and the low-income worker who needs the money and decides to take a chance. As they drop out, the cost goes up for the older workers and the less healthy, and the spiral begins. The whole thing unravels. We call it adverse selection.

It is the lowest income worker, as always, who will be hit first and hardest. Then the chickens will come home to roost in higher Medicare and Medicaid costs, welfare costs, and hospital bad debts, not to mention the indirect cost in human terms and lost productivity.

Under current law, employers are allowed to deduct contributions made to an employee health benefit plan, and employees are not required to include these amounts in their taxable income. Last November, Treasury proposed to limit the amount an employer may contribute to an employee health care benefit plan without creating taxable income for employees. The limit was $70 per month for an individual and $175 per month for a family. Contributions by an employer in excess of these limits, would be taxable to the employee.

Treasury then recognized there was a national policy to promote health care services. It urged, however, that the caps were necessary to reduce overconsumption and to produce more revenue. The estimated increase in revenue was $34.3 billion for the period 1986 through 1990. That proposal should be rejected because the burden of the tax cap would fall unequally on workers depending upon where they work, their ages, and their occupations. The cap would discriminate against workers in areas where health care costs are relatively high such as California and New York, where employers must pay twice as much or more for health care coverage as is paid in areas of relatively low health care costs such as North Dakota.

The tax would also discriminate against worker groups composed primarily of older workers whose health care costs are greater than those for younger workers, as the average age of workers from industry to industry throughout the United States varies con-

siderably. Plans covering workers with a higher average age are more costly and these workers would be subjected to higher taxes under that proposal.

Finally, the tax would fall disproportionately upon workers employed by small businesses and workers employed in high-risk or hazardous occupations. Small businesses typically pay more for health care coverage because of higher administrative costs and greater variability of claim costs. High-risk workers 'costs are, obviously, higher because of the greater risks and higher resulting claims.

The administration's latest version of the employee health tax, taxing an employee on the first $10 for individual coverage and on the first $25 for family coverage, a so-called floor, is a floor that is dangerous. Since it would initially cost each employee relatively little, it has superficial appeal. However, it would be like the Trojan horse—accepting the floor would undermine the principle that health care benefits should not be taxed.

The taxation of health benefits at this time at a level that yields relatively little revenue appears to be an effort to establish a precedent for not only taxing health benefits, but also extending this form of taxation to other employee benefits in future years. Building on this precedent, Congress could substantially increase the level of future taxation by simply raising the maximum tax liabilities.

The proposed tax on health benefits would also raise payroll taxes for most employers and employees. When Social Security taxes are included, the tax is regressive since lower- and middle-income people would have a relatively higher increase in taxes. In fact, nearly one-third of the total revenue raised by this proposal would come from the payroll tax.

A recent study indicates that smaller employers tend to buy less extensive health protection for their employees than do the larger employers. They also tend to pay a lower percentage of the premium cost. Thus, under this latest proposal, employees of smaller employers who already have to pay more of their own dollars to get a smaller health protection package would pay the same health tax as employees who get extensive protection totally paid by their employers.

Smaller employers would also be faced with a relatively heavy administrative burden in implementing this proposal in order to collect a relatively small tax per person. Just consider the cost of implementing this proposal for one single employee. To collect a monthly tax averaging $1.50, the employer must impute income, pay Social Security taxes, adjust benefits for life insurance, group disability insurance, group pensions, savings plans, et cetera.

Congress has successfully over many decades encouraged the private sector to construct a broad, effective system of employee benefits. To change directions now at a time when Government programs for medical care are being squeezed would be very wrong. Although the Government can cause the scope of group health insurance protection to shrink, the need for that protection will not change. We are not talking here about tax loopholes for the privileged few. We are talking about the sick; we are talking about the disabled among working class Americans.

The administration proposals to change the treatment of retirement savings plans are also of concern to employers, particularly smaller employers. Revising the rules for section 401K plans, for distributions, for benefit forfeitures, for determining whether coverage is nondiscriminatory, and so forth, would add to the complexities small employers face in providing retirement plans for their employees. For such employers, the overwhelming need is for stability of law and regulation.

The continuing proposals for change that come from the Treasury year after year make it difficult for insurers to design and market products for small employers and make it difficult for small employers to be able to administer plans or to be sure that they are in compliance with all laws and regulations.

Having to make frequent changes in plans is both disruptive and expensive. We think most small employers would be grateful for a moratorium on new legislation in this field, particularly legislation that would complicate their administration of retirement plans.

Employee benefit plan coverage is not yet perfect or complete, but the bulk of the working population does have protection paid for by employers and by employee contributions. Change the tax treatment that made the growth of private plans possible, and millions of people may be financially damaged.

Senator, I would also like to include with my testimony the HIAA booklet, "The Case Against the Taxation of Employee Health Benefits," which I have given to Ms. Arnold.

Thank you very much.

Senator DIXON. Thank you, and it will be included in the record, Mr. Eckert.

While I tend to sympathize with the large part of your statement that has been given us for the record here, Mr. Eckert, I wonder whether you would care to comment upon the distinction that was drawn here by Mr. Moats in his testimony, which is to say that I am somewhat persuaded that Treasury I at least excluded lower income people in large measure from the impact of the taxation as distinguished from Treasury II which is, in effect, kind of a minimum tax on everybody that receives these health benefits.

I note, incidentally, your comments about California, Illinois, and New York—the higher cost areas vis-a-vis, for instance, North Dakota, which I think has merit. We have in the past, as you know, taken that into consideration in some of our Federal regulations concerning hospital costs and things of that kind under Medicare.

I support your point of view that we ought not tax fringe benefits at all, but assuming that the Congress in the exercise of its will ultimately would say that something needs to be done in this area, wouldn't you think that some kind of a cap that perhaps took into account cost factors around the country would be fairer for at least low-income people in many cases than some kind of a minimum tax?

Mr. ECKERT. There are several inequities, and you mentioned one, the location—the New York, California situation on cost, and they would be caught by the cap. You have several other inequities, though. You have the aging problem. It could be in a small group or a large group. If you have a group of employees that are

in the upper years versus another group that has employees at the younger age, the tax would hit the older employees in that case and miss the younger group completely.

You have a situation, I think, that you might be interested in for smaller groups. Smaller groups tend to pay a higher premium rate than a large group, as I mentioned, because of administrative costs and especially because of the fluctuation in claim experience between the two groups. So you might have a tax there that would hit the smaller employer more than the larger employer; the employee of a smaller group versus the employee of the larger employer and so forth. You have those kinds of inequities.

You also have the inequity of the hazardous occupations paying the tax where, if you were in a nonhazardous occupation, you would not pay a tax. You have those inequities. There are problems whether you have a floor or whether you have a cap.

Senator DIXON. Yes.

Let me just pursue that a moment further. I suppose there are outrageous cases in the country of excessively generous health plans for perhaps major executives of major corporations. Is there some kind of a valid argument that there ought to be at some level at least some kind of a cap above which you would pay tax or would you reject that out of hand automatically?

Mr. ECKERT. That has been one of the arguments. I believe that in the past that there might have been some merit to that. However, employers are competing in the worldwide economy. They are concerned about their health care costs. They are doing more about not giving that overgenerous benefit that we have seen in the past. We are seeing more deductibles. We are seeing more coinsurance. We are seeing cutbacks rather than the extensive coverages. I don't think we have the difference between the low-paid employee within a group and the high-paid employee because there would be the discrimination there which is not allowed—which should not be allowed.

Senator DIXON. I guess one of the obvious things, Mr. Eckert, that one has to comment about—again as someone who is sympathetic, may I say, to your point of view and that expressed by Mr. Moats, the prior witness—is the amount of dollars. I have said so many times everybody is for tax simplification and everybody is for tax reform. The polls show something like 84 percent of the people like the idea. Newspapers from the left to the right all have editorialized about what a grand idea tax simplification is. Of course, all of us recognize immediately that when you reduce the categories down to three or even four, as the chairman of the House Ways and Means Committee is now suggesting, you have an immense revenue shortfall on the other side. You have to close some loopholes. Now obviously one man's loophole is another man's lifeblood.

I would say, of all the loopholes we are discussing, this is probably the one with the broadest appeal in the country, but somewhere in the figures here it was suggested that—in your testimony—one of the plans earlier surfaced by Treasury would have involved $34 billion. I guess one has to observe that that ain't chicken feed.

Mr. ECKERT. That is for sure.

Senator DIXON. When you have this immense revenue shortfall and you are looking for revenue, obviously these are the kinds of problems that are presented by tax simplification, are they not?

I guess, though, finally, you would argue that of all of them this is the one least acceptable and most onerous to the public at large.

Mr. ECKERT. I think it is most acceptable because we are talking of fewer dollars to people, but I think that we have done a tremendous job in this country with our medical care services. I think the tax incentives have been a means of accomplishing that. We have not seen that in some of the other countries in the world.

Senator DIXON. Incidentally, is that true? That is interesting. Do other countries tax health benefits; do you know?

Mr. ECKERT. I believe most of them have national health insurance of some sort.

Senator DIXON. Oh, I see.

Mr. ECKERT. They don't do it in the private sector.

Senator DIXON. Well, that costs as well, of course, obviously.

Well, I thank you, Mr. Eckert. Thank you very much.

Mr. ECKERT. Thank you.

[The prepared statement and supplemental information of Mr. Eckert follows:]

Statement

of the

HEALTH INSURANCE ASSOCIATION OF AMERICA
and the
AMERICAN COUNCIL OF LIFE INSURANCE

on

TAXATION OF EMPLOYEE BENEFITS

Presented by

Ralph J. Eckert

Chairman and Chief Executive Officer
Benefit Trust Life Insurance Company

Before the

Senate Small Business Committee

June 10, 1985

Chicago, Illinois

Senate Small Business Committee Hearing
on the Taxation of Employee Benefits
June 10, 1985

My name is Ralph J. Eckert. I am Chairman and Chief Executive Officer of Benefit Trust Life Insurance Company, and Immediate Past Chairman of the Health Insurance Association of America. I am appearing here today on behalf of the Health Insurance Association of America and the American Council of Life Insurance. The HIAA has 350 member companies who write over 85% of the health insurance written in the United States by insurance companies. The ACLI has 615 member life insurance companies who write about 95% of the life insurance written in the United States and hold 97% of the assets of insured pension plans. Many of the members of ACLI also write health insurance.

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First, what has it accomplished?

Health insurance provided by employee benefit plans falls into two broad categories -- benefit payments for hospital, medical and dental expenses; and income payments to disabled workers, or disability insurance.

By the end of 1982, including spouses and children, approximately 162 million persons under age 65 were covered by some form of group health protection. A 1980 study of employees with insured major medical plans showed that three-fourths had a maximum benefit of no less than $250,000 -- and nearly half would pay to $1 million or were unlimited.

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possible. The consumer interest is also protected through our system of state insurance regulation, covering such areas as group policy and certificate provisions, group conversions, and so forth. In fact, due to the flexible nature of the business, employees may continue to maintain medical expense protection upon termination of employment by either converting to an individual policy or continuing benefits under the group plan for various periods. In many instances, coverage is also continued for a specified time for dependents who lose eligibility due to an employee's death or divorce.

A particularly relevant example of how the competitive insurance market place served the public interest was the development of group insurance for small employers with as few as one or two employees. According to Department of Commerce data, there were 4.3 million firms with one to forty-nine employees in 1980. These small groups probably provide employment for over 15 million workers. To serve that market, insurers developed pooling techniques and simplified underwriting rules and, as a result, small employers today have a wide choice of plans. The stimulus of tax incentives and the willingness of carriers to voluntarily enter the small group market have been of great benefit to small employers and their employees and families. As a result, small firms can today obtain many coverages once only available to large groups, and can fully realize the advantages of the tax incentives in the law.

Overall, the encouragement of health insurance coverage through tax incentives has been enormously successful in terms of social and economic accomplishments. The present system of employement-related health benefits was built up over several decades, and works very well. Americans have come to regard employer-sponsored health protection almost as an automatic feature of employment, providing benefits of great value. In our view, no change should be made in tax incentives which might impair the ability of the private sector to provide essential insurance protection to the public.

What the government has done for the elderly with Medicare and the poor with Medicaid -- at a cost this Committee well knows -- the private sector has done for the bulk of working class America. And the key to that -- making it all possible -- is a favorable tax policy. Take it away, and you place the whole mechanism in jeopardy.

Here is why. To make it work, you need to cover essentially all the employees in the group. Now the employer pays most, or all, of the premium, and the employee pays no tax. So "everybody" signs up.

But, increase the direct cost to the employee, through taxes or otherwise, and they begin to drop out -- the young, the healthy, and the low-income worker who needs the money and decides to take a chance. As they drop out, the cost goes up for the older workers and the less healthy, and the spiral begins. The whole thing unravels. We call it adverse selection.

It is the lowest income worker, as always, who will be hit first and hardest. Then the chickens will come home to roost -- in higher Medicare costs, welfare costs, and hospital bad debts, not to mention the indirect costs in human terms and lost productivity.

Under current law, employers are allowed to deduct contributions made to an employee health benefit plan, and employees are not required to include these amounts in their taxable incomes. Last November, Treasury proposed to limit the amount an employer may contribute to an employee health care benefit plan without creating taxable income for employees. The limit was $70 per month for an individual and $175 per month for a family. Contributions by an employer in excess of these limits would be taxable to the employee. Treasury then recognized there was a national policy to promote health care services. It urged, however, that the caps were necessary to reduce "overconsumption" and to produce more revenue. The estimated increase in revenue was $34.3 billion for the period 1986 through 1990.

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The tax would also discriminate against worker groups composed primarily of older workers whose health care costs are greater than those for younger workers, as the average age of workers from industry to industry throughout the United States varies considerably. Plans covering workers with a higher average age are more costly and these workers would be subjected to higher taxes under the proposal.

Finally, the tax would fall disproportionately upon workers employed by small businesses and workers employed in high risk or hazardous occupations. Small businesses typically pay more for health care coverage because of higher administrative costs and greater variability of claim costs. High risk workers' costs are, obviously, higher because of the greater risks and higher resulting claims.

The Administration's latest version of the employee health tax -- taxing the employee on the first $10 for individual coverage and on the first $25 for family coverage -- a so-called "floor" -- is a floor that is dangerous. Since it would initially cost each employee relatively little, it has superficial appeal. However, it would be like the Trojan Horse -- accepting the floor would undermine the benefit industry's principle that health care benefits should not be taxed. The taxation of health benefits at this time at a level that yields little revenue appears to be an effort to establish a precedent for not only taxing health benefits but also extending this form of taxation to other employee benefits in future years. Building on this precedent, Congress could substantially

increase the level of future taxation by simply raising the maximum tax liability.

The proposed tax on health benefits would also raise payroll taxes for most employers and employees. When Social Security taxes are included, the tax is regressive since lower and middle income people have a relatively higher increase in taxes. In fact, nearly one-third of the total revenue raised by this proposal would come from payroll tax.

A recent study indicates that smaller employers tend to buy less extensive health protection for their employees than the larger employers. They also tend to pay a lower percentage of the premium cost. Thus, under this latest proposal, employees of smaller employers, who already have to pay more of their own dollars to get a smaller health protection package, would pay the same health tax as employees who get extensive protection totally paid by the employer.

Smaller employers would also be faced with a relatively heavy administrative burden in implementing this proposal in order to collect a small amount of tax per person. Just consider the cost of implementing this proposal for one single employee -- to collect a monthly tax averaging perhaps $1.50, the employer must impute income, pay Social Security taxes, adjust benefits for life insurance, group disability insurance, group pensions, savings plans, etc.

Congress has successfully, over many decades, encouraged the private sector to construct a broad, effective system of employee benefits. To change directions now, at a time when government programs for medical care are being squeezed, would be very wrong. Although the government can cause the scope of group health insurance protection to shrink, the need for that protection will not change.

We are not talking here about tax loopholes for the privileged few. We are talking about the sick. We are talking about the disabled among working class Americans.

The Administration proposals to change the treatment of retirement savings plans are also of concern to employers -- particularly smaller employers. Revising the rules for Section 401(k) plans, for distributions, for benefit forfeitures, for determining whether coverage is nondiscriminatory, and so forth, would add to the complexities small employers face in providing retirement plans for their employees. For such employers, the overwhelming need is for stability of law and regulation.

The continuing proposals for change that come from the Treasury year after year make it difficult for insurers to design and market products for small employers, and for small employers to be able to administer plans or to be sure that they are in compliance with all laws and regulation. Having to make frequent changes in plans is both disruptive and expensive. We think most small employers would

be grateful for a moratorium on new legislation in this field for the next few years -- particularly legislation that would complicate their administration of retirement plans.

Employee benefit plan coverage is not yet perfect or complete -- but the bulk of the working population does have protection -- paid for by employers and by employee contributions. Change the tax treatment that made the growth of private plans possible, and millions of people may be financially damaged.

The Case Against The Taxation Of Employee Health Benefits

Health Insurance
Association of America

March 1985

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The Tax on Employee Health Benefits

The health insurance industry strongly opposes taxation of employee group health insurance plans. The following points illustrate why this proposal will not contain health care cost inflation and is an improper method for raising Federal revenue.

TAXING HEALTH BENEFITS IS BAD HEALTH POLICY

● **A health tax dismantles the economic safety net provided to American workers by private enterprise** – Present tax policy has effectively replaced the need for a costly national health insurance program. The development of private employee group health insurance has opened channels of insurance to millions of workers regardless of age, sex, physical condition, or character of employment. In doing so, the contributions of employers and employees have drastically reduced pressure on charities, social, and governmental services in general and Medicare and Medicaid in particular.

For employee group insurance to work, essentially all employees in a group must be covered. But increase direct costs to the employee, through taxes or otherwise, and young, healthy and low-income workers drop out. As these workers leave the group, costs for older and less healthy workers go up in the form of higher premiums and out-of-pocket costs. And, as usual, it is the low-income worker who will be hit the hardest. In summary, take away favorable tax policy, and you move the burden from the private to the public sector.

● **A health tax penalizes older workers** – Elderly groups tend to use health care more frequently than younger, healthier workers. Hence, the cost of health insurance for groups including more than the average number of older workers not only will be higher in price, but could discourage many employers from hiring older workers. This same principle may be applied to other high "risk" groups, including women and the disabled.

● **A health tax penalizes those in hazardous, high-risk occupations** – Some groups, such as iron workers or coal miners, are usually considered a higher risk, and are typically charged higher health insurance premiums. These groups could be unfairly taxed while other groups with similar coverage, for example clerical workers, would be unaffected.

● **A health tax could result in reduced coverage for preventive care services** – In trying to avoid taxation, rational consumers will not reduce expensive hospital coverage, but instead will eliminate cost-effective preventative services such as dental care, vision care, mental health benefits, and alcohol and drug abuse services. Taxing health benefits will do nothing to contain the driving force behind health care cost inflation, namely hospital costs, but instead may have a detrimental impact on consumers' health status.

TAXING HEALTH BENEFITS IS BAD TAX POLICY

● **A health tax is a regressive tax** – A decrease in employer provided health benefits and the resultant increase in out-of-pocket health costs due to a health tax would hit hardest on those least able to afford it. In data presented to Congress in 1983, the Employee Benefit Research Institute (EBRI) stated that "as a proportion of income, persons at the lowest level of income (those reporting less than $10,000) would pay more than six times the amount of tax than would persons with income over $50,000."

EBRI concluded that "... current tax policy probably raises private coverage rates significantly among lower-income worker households, households with fragmented employment histories, younger households, and both single-person and single-parent households." Taxing employee health plans could seriously undermine these successes.

● **A health tax is a form of "double taxation"** – The Health Insurance Association of America estimates that Medicare and Medicaid payment practices resulted in $8.8 billion being shifted to patients covered by private health insurance in 1984 to make up for government underpayment to hospitals. For the government to shift these costs to the private sector and then put a tax on the resulting higher insurance premiums is patently unfair. Further, as pointed out above, it will be the sick and those most dependent on health insurance who will bear the burden of this cost shift.

● **A health tax unfairly affects certain geographic areas** – The cost of health care is higher in some areas, such as large metropolitan cities. A single national tax cap does not take geographic differences into account, and thus would particularly penalize those in high-cost areas. Conversely, it would allow the tax-free purchase of much more generous benefit plans by employers in low cost areas.

● **A health tax would penalize employees of small businesses** – Small employers generally pay higher premiums than large employers for comparable plans. Hence, small employers would represent a disproportionate number of the employees affected by a health tax. Further, many small businesses have indicated that they would be forced to

terminate their group health plans due to the increased administrative burden of adjusting payroll and benefit procedures to a health tax.

● **A health tax would seriously curtail competition in the health care field**—The Reagan Administration champions the long-range effect of containing health care costs through increased competition in the marketplace. Ironically a health tax could increase health care costs by thwarting competition. Cost effective alternative delivery systems, such as health maintenance organizations (HMOs), would be less attractive because they offer more comprehensive coverage at higher than average premiums.

Indeed, the Group Health Association of America, the national trade organization for HMOs, opposes the health tax proposal because it may do "lasting and irreparable damage to the ability of HMOs to compete in the market and therefore to their continued growth and development."

The Federal budget deficit should not be balanced on the backs of the sick and disabled. Present tax policy has fostered comprehensive private health coverage for the majority of working class Americans. The removal of favorable tax policy places this entire system in jeopardy.

Introduction

The taxation of employee health benefits is an issue currently receiving much attention in the Federal government. The November 1984 Treasury plan for tax reform includes a proposal to tax employer health contributions over specified amounts beginning in 1987. The Bradley-Gephardt tax reform proposal provides for the taxation of all such employer contributions. Various other legislators in Congress have stated their intent to reassess the current tax exempt status of employee benefits.

Tax proposals of this kind are not new. The Reagan Administration has previously advocated the taxation of employer health contributions, and is clearly continuing its support of the idea. Opposition, however, has been widespread in the private sector.

The issues involved in taxing employee health plans are complex, and need to be thoroughly explored. The existing tax exclusion for such benefits exemplifies an enormously successful governmental health care policy. Today, as a result of that policy, most Americans enjoy health insurance protection through private sector employer based group plans. The removal of part or all of the tax exclusion will impair the ability of the private sector to protect employees through group insurance. The consequences of that can intensify pressure for expanded public insurance programs, despite the government's continuous struggle to control Medicare and Medicaid expenditures.

The arguments set forth by the proponents of health benefit taxation fall into three major areas, as follows:

● Tax Equity

It is claimed that the tax exempt status of employee health benefits favors high income employees, and that the tax preference is unfair to those without employer provided health benefits. In our view, the tax proposal will not result in greater equity among taxpayers. Instead, it will introduce much more inequity as compared to the present system.

● Revenue

Supporters maintain that the taxation of employee health benefits will curb the erosion of the tax base. There are those who see that as a way to raise additional revenue for deficit reduction, while others hope it will lead to reduced marginal tax rates. In our view, neither result is realistic as long as employers can implement tax avoidance arrangements. The only sure outcome is that the administrative burden on employers will be difficult and costly.

● Cost Containment

The advocates believe that taxing health benefits will result in greater health care cost containment. That view, however, is based upon implausible theoretical considerations and little in the way of cost containment can be expected from the tax.

The Congress should weigh carefully whether the taxation of employee health benefits will produce the claimed results, and whether it is wise to weaken our system of private health protection by imposing such a tax.

In our view, few of the alleged benefits will materialize. We will have, instead, only more inequity among employees, frustration among employers, and the pressure for expansion of public insurance programs.

Tax Equity

A major objective of employee health benefit taxation is said to be greater equity among taxpayers. Critics of the current tax preference have noted that each dollar of tax free health benefits is worth more to a high income employee than to a lower paid worker. Others justify reducing the tax advantage on the basis that it is not available to workers without employer provided health benefits.

Let us examine whether the proposal to tax employee health benefits will actually result in greater equity.

The Impact of the Proposed Tax on Employees

In order to see the equity aspects of health benefit taxation, we shall examine how the cost of group coverage will translate into taxable income under the November 1984 Treasury proposal.

The annual cost of a group health insurance plan is determined by many factors. The most important are the coverages included, the age and sex composition of the group, the health status of the persons covered, the size of the group, the type of industry, and the geographical area of the country.

We shall first consider the effect of medical cost levels in the area in which the firm is located.

A typical employee would be subject to very different amounts of taxable income depending upon where he lived. In Table A there is shown for each of ten cities, the estimated increase in 1987 taxable income for a male employee aged 40-44, under the proposed Treasury plan, assuming he represented the average for the group.

The data are based upon the average of 1985 premium rates of five nationwide carriers, for a comprehensive medical expense plan.

Table A shows that the proposed tax will fall heaviest upon employees in the major cities of the nation, where medical costs are highest. If the employee worked for a 2-9 life group in Los Angeles, where the employer paid the full premium, his taxable income would rise by $1,193 if single, and $4,330 if also covered for dependents.

If the same employee and firm were in Greenville, South Carolina, the taxable income would increase only $36 if single, and $616 if dependent coverage were included.

A similar pattern occurs when a large group is involved, or when the employer pays only 75% of the cost of the plan. In low cost areas, the flat nationwide exemption amounts offset all or nearly all of the employer contribution to the group plan.

It is patently unfair to impose a tax structure that virtually exempts from taxation employees in low health care cost areas, but which heavily taxes workers in expensive urban areas. The Treasury plan is very inequitable for an employee in our largest cities, compared to an employee with the same annual income living where health costs are not high.

Impact on Small Business

Table A also reveals the much higher taxable incomes that would result for employees of small firms, as contrasted to workers in large groups where premium rates reflect lower carrier expense levels.

For example, an employee of a small business in Manhattan would have increased taxable income of $2,488 with family coverage and the employer paying the full premium.

If that same employee worked for a large Manhattan firm of 500 employees, with the same non-contributory coverage, his taxable income would increase by only $1,393, which is 44% less.

The extreme inequity among taxpayers by geographical area and size of group would be very distressing to many employees, especially those working for small firms in high cost cities.

If we proceed one step further, to see how the Treasury tax proposal would affect high and low income employees, we uncover another gross injustice. In Table B, there is shown the total increased federal income and Social Security taxes that would be paid in 1985 in certain cities, if the Treasury proposal were already effective. The taxes are shown for an employee in two annual income categories, $15,000 and $35,000.

It is evident from Table B that the employee earning $15,000 per year pays by far the largest percentage increase in tax, if he works for a small firm in Los Angeles, where the plan is non-contributory, his total federal income and Social Security tax would increase by $718 which is 36% more than his taxes under current law.

These percentage increases are far greater than for higher income employees, which reveals the very regressive nature of the proposed tax. The $15,000 per year worker, on a percentage basis, will pay about twice more in taxes as the employee earning $35,000.

Since the increase in taxable income is the same for all employees regardless of cash earnings, lower income employees will be exposed to the

Table A

Estimated Increase In 1987 Taxable Income If Employer Contributions* Were Taxable Above $70/Mo Individual, $175/Mo Family

City	2-9 Life Group		500 Life Group	
	Non Contributory Plan	Employer pays 75% of Cost of Plan	Non Contributory Plan	Employer pays 75% of cost of Plan
Individual				
Los Angeles	$1193	$ 685	$ 528	$ 186
Miami	1009	547	473	145
Chicago	726	335	364	63
New York†	626	260	341	46
Dallas	458	134	82	–
Knoxville, TN	347	50	–	–
Jackson, MS	254	–	–	–
Macon, GA	205	–	–	–
Fargo, ND	185	–	–	–
Greenville, SC	38	–	–	–
Family				
Los Angeles	$4320	$2715	$1946	$ 935
Miami	3674	2231	1729	818
Chicago	2822	1592	1484	566
New York†	2488	1341	1393	520
Dallas	1975	956	648	–
Knoxville, TN	1575	656	239	–
Jackson, MS	1304	453	305	–
Macon, GA	1166	350	267	–
Fargo, ND	1088	291	135	–
Greenville, SC	616	–	–	–

† Manhattan

*Based on a projection to 1987 of the average of 1985 premium rates of five nationwide carriers, for a comprehensive medical expense plan

higher percentage increase in tax in all groups where the exemption amounts are exceeded.

Although the Treasury plan is intended to be revenue neutral in the aggregate, it is extremely questionable whether other reductions can be sufficiently fine tuned to avoid shifting an excessive tax burden to those who can least afford it.

Furthermore, the "revenue neutrality" of the Treasury plan applies only to the Federal income tax, but we must assume that the resulting increases in taxable income also will be subject both to Social Security taxes and those state income taxes which "piggy-back" the Federal income tax. These tax increases, which will not be offset by the proposed Treasury rate reductions, will also fall hardest on lower income employees.

Tax Inequity

The proponents of employee health benefit taxation have long argued that greater tax equity as between high and low income workers will result from this tax. It is true that under the

Table B

Estimated Tax Increase If Employer Health Contributions Were Taxable In 1985

City	Size of Group and Employer Contribution	Annual Cash Wage: $15,000 Increase In Taxes*	$15,000 % Increase	$35,000 Increase In Taxes*	$35,000 % Increase
Los Angeles	2-9 employees, employer pays all	$718	36%	$1,042	17%
	2-9 employees, employer pays 75%	409	21	612	10
	500 employees, employer pays all	267	14	407	7
Chicago	2-9 employees, employer pays all	430	22	642	10
	2-9 employees, employer pays 75%	204	10	312	5
	500 employees, employer pays all	180	9	276	4
New York†	2-9 employees, employer pays all	365	19	552	9
	2-9 employees, employer pays 75%	161	8	246	4
	500 employees, employer pays all	170	9	260	4

*Based on Federal Income and Social Security taxes for a family of four with no other income. In 1985, the total of such taxes are $1,971 for the $15,000 wage earner, and $6,256 for the $35,000 wage earner, excluding any tax on health benefits. Itemized deductions are assumed to be the greater of $3,540 and 23% of adjusted gross income. Increases in state income taxes not included.

†Manhattan

current graduated income tax structure, a dollar of employer contributions to health insurance is more valuable to higher income employees. That, however, applies to all tax preferences such as interest paid, local taxes and charitable contributions. If that is a matter of inequity, then the progressive tax rate scale is to blame, not any one example of tax preference.

Actually, as may be seen from Table B, when these employer contributions become taxable it is the *lower* paid worker who is faced with the greatest proportional increase in federal income and Social Security taxes.

It is difficult to understand the advocacy of this tax in the name of greater equity for low wage earners, when it is they who will be the most disadvantaged by its enactment.

There are many ways in which the Treasury proposed tax will create inequities other than through geographical area differences, size of group, and the regressive burden on low income workers. Let us see how they occur.

Group health insurance is purchased by employers for the benefit of their employees, frequently with the advice of experts in the field. The employer usually decides upon the coverage to be provided, except when the insurance plan is the subject of collective bargaining. Normally, the cost of the plan is either borne entirely by the employer, or borne in large part by the employer with some employee contribution required.

If the employer's cost of the plan were to become taxable income to the employees, such cost would have to be allocated to each employee as imputed income, whether or not there is an exemption of some dollar amount.

To be fair, each employee's imputed income should be based upon the actuarial value to him of the health insurance plan. Essentially, that means an annual determination of each employee's share of the employer's cost as a function of the principal actuarial factors of age, sex, coverage for dependents and place of residence.

The extent to which this can be done on a reasonable basis depends upon premium rating practices and available data, which generally differ for small and large groups.

Small Groups

Let us first consider employees who work for firms with less than fifty employees. According to United States Department of Commerce data, there were 4.3 million firms with one to forty-nine employees in 1980. Based upon insurance company data, these small groups probably provide employment for over 15 million workers. There are many carriers active in the small group market and each offers a variety of plans for the employer to choose from.

A common characteristic of the plans sold to small employers is that schedules of age and sex specific premium rates are used, which are also adjusted for the locality in which the firm is located. The premium rates may also be adjusted to reflect the industry classification of the firm. With this kind of rate structure, there is a specific premium for each employee reflecting the actuarial rating elements of age, sex, dependents coverage, type of industry, and locality.

Such premium rates reasonably represent the actuarial value of the plan to the employee, as calculated by the insurance company, and the employer's share of the premium could be readily used as imputed income.

According to the November 1984 Treasury plan, however, the actuarial value of the health benefit plan will not be the basis for determining additional taxable income. The report states that "The annual cost of coverage with respect to an employee would be calculated by determining the aggregate annual cost of providing coverage for all employees with the same type of coverage (individual or family) as that of the employee, and dividing such amount by the number of such employees."

Here we see another source of inequity for employees in small groups, where actuarial value is readily available from the age and sex distinct premiums paid by the employer.

Take, for example, a self-employed 55 year old accountant with a 20 year old secretary who has purchased a small group plan. The premium for the accountant is much higher than that for the secretary, but the Treasury would give each employee imputed income equal to the average of their premiums. Clearly the secretary is subsidizing the accountant with respect to allocated imputed income.

Speaking more generally, if each small group employee were assigned imputed income on the basis of an average premium, the young would subsidize the old and males would subsidize females. And, of course, there would still be wide differences in tax liability by area as shown in Table A.

Larger Groups

Larger groups generally involve those with at least 50 employees, and can range up to the hundreds of thousands for the largest employers. For such groups, premium rating practices are quite different from those described for small groups.

Employers with insured plans typically remit premium on the basis of monthly "billing" premiums, but the final cost depends upon actual claim experience, expenses and other factors for the policy year. For the present purpose, it will be assumed that billing premium reasonably approximates the cost of the plan.

The premium is typically expressed as a specified monthly premium for employee coverage regardless of age and sex. There are one or more additional premiums for dependent coverage, depending upon the number of separate dependent classifications used. These are essentially averages that through experience rating incorporate the groups actuarial characteristics of age, sex, dependent composition, geographical distribution of employees, type of industry, and claim experience.

Such average premiums are changed annually to reflect recent claims experience, and the anticipated increases in health care costs for the coming year. This would include provision for inflated health care charges due to cut backs in Medicare and Medicaid payments, i.e. the "cost shift" to privately insured persons.

Since the per employee and per dependent unit premiums are adjusted each year on an overall basis, and remain broad averages, the actuarial value of the plan for each employee is not readily available. In this case, the Treasury method for allocating imputed income is still inequitable to employees.

Young employees would be allocated imputed income in excess of the actuarial value of the plan to them. Older employees would be allocated less imputed income than their actuarial value, and would enjoy a subsidy.

Under this system, employers might become reluctant to hire older workers. Likewise, a firm's employees living in low cost areas would subsidize their fellow employees living in high cost areas. In any given group of employees, there would be much cross-subsidy, or redistribution of imputed income for tax purposes.

Under the Treasury plan, with exemption amounts, an entire group might escape imputed income if the group's average age were low, or the bulk of the employees lived in low cost areas, or the group enjoyed better than average health. Conversely, a group with a high average age, or heavy concentration of employees in high cost areas, or worse than average health, would be much more likely to be taxed.

The impact on individual employees could vary sharply. For example, an employee living in Los Angeles might not have any imputed income if the rest of the firm's employees worked in Greenville, South Carolina. That would be very unfair to other Los Angeles workers employed in smaller local firms, and exposed to large taxes.

Under this approach, an employee's imputed income would mainly depend upon the overall actuarial characteristics of his firm, and not at all on the actuarial value of the plan to him.

Another example of this unpredictability is when an employee changes employment from one group to another with a different age or sex distribution, different mix of employees by geographical area, or different type of industry. Under the Treasury method, his imputed income may change sharply in either direction.

For example, a Washington, D.C. representative of a national bank could suddenly have substantially more imputed income if he or she changed employment to represent a large mining company, with no change in coverage. Similarly, if a representative of a Macon, Georgia firm changed to represent a Los Angeles firm, imputed income would also increase.

Overall, many inequities exist in allocating imputed income. They are such that inevitably many employees will be either lightly taxed or not at all, at the expense of others who will carry a disproportionate share of the burden. Employees will often be exposed to tax in a haphazard and unpredictable manner especially upon changing employment, and will likely find explanations difficult to understand or accept.

Persons Without Employer Provided Health Benefits

The proponents of employee health benefit taxation claim that the present system is unfair to those without employer plan coverage. Such persons who desire health insurance normally purchase individual policies. The unfairness lies in the fact that premiums for individual policies are paid with after-tax dollars, as contrasted to the non-taxable status of employer contributions to group health insurance.

In order to place this matter in perspective, we have estimated that as of the end of 1982, about 175 million Americans under age 65 were either covered under employee health plans or under individual health policies, or both. Of that number, we estimate that about 13 million had individual insurance only. Thus the advocates justify curtailing a tax preference that benefits 162 million persons, in deference to 13 million persons who have only individual insurance.

In our view this "inequity" between those with and without employer coverage is greatly exaggerated, and cannot justify the imposition of a tax with so many negative effects on employees. In our mobile society, workers often change employment and over most of their working careers will be covered by employer health plans.

If there are intervals between employer provided group insurance, individual policies are available, and that accounts for many of the 13 million with individual coverage. Such policies are usually lapsed when the insured goes to work for a firm with group coverage.

If there is an "injustice," it concerns those who never have access to employer provided group insurance. We believe that such persons represent a very small proportion of the workforce. To the extent that certain workers depend upon individual policies for long periods of time, the Administration and Congress should provide tax relief. That may be done directly by allowing such workers to deduct part or all of their individual health insurance premiums.

Until recently there was provision in the tax law to deduct part of such premiums, but that was repealed in 1982. It would seem wiser for Congress to reassess whether the individual premiums of a relatively few workers should be exempted, rather than to impose an inequitable tax on most employees.

The Impact of Health Benefit Taxation on Employers and Federal Revenue

A major argument for the taxation of employee health benefits rests upon the belief that the growth of such benefits has eroded the nation's tax base. As a result, marginal tax rates are said to be higher than necessary, and that health benefit taxation represents desirable tax reform. Other advocates are mainly concerned with the federal deficit, and simply see the taxation of employee benefits as a new source of federal revenue.

Tax Reform

There is general agreement that the current tax code is very complex. Tax reform has become a popular issue, and most proposals involve the elimination or curtailment of various deductions and exclusions from income. There are a number of choices that could be made, such as deductions for state and local taxes, interest paid, charitable contributions, IRA contributions, etc.

If tax reform is to involve such a broadening of the tax base, a guiding principle should be that all taxpayers are treated fairly and [illegible] generally in accordance with ability [illegible]ity.

In our view, employer contributions to health plans is one of the worst choices that could be made to expand the tax base. As noted in the section on connection with the Treasury plan, it would produce a host of inequities in the distribution of taxable income among taxpayers. Furthermore, it is a highly regressive tax since the allocated taxable income does not significantly vary by cash income level.

Even if the tax reform were intended to be revenue neutral in the aggregate, through reduced tax rates, it is likely that the bulk of the tax burden would fall on those that can least afford it. This cure would be truly worse than the disease.

Deficit Reduction

With respect to those who anticipate a new source of revenue for deficit reduction, there may be considerable disappointment. The imposition of this kind of erratic and arbitrary taxation will create many problems for both employers and employees. The resulting changes in behavior are not very predictable, and the actual new revenue may fall short of that expected.

Let us first examine the practical problems that would be faced by employers. The imposition of a tax on employer contributions to a group health insurance plan, will increase the employer's administrative costs. That will reduce federal revenue from corporate income taxes to the extent that corporate profits are reduced, or increase the cost of goods and services to consumers. The following considerations illustrate the likely impact on employers.

(i) Large employers can have many health insurance plans in effect, but there is usually not more than one at a given location or for a specific bargaining unit. All such plans may not have been rated separately in the past, but now each would have to be separately treated for imputed income purposes.

It is not uncommon for a large employer to have dozens, or a hundred or more plans in effect, reflecting collective bargaining activity with many unions. The need to treat a multitude of plans separately for imputed income purposes will increase administrative costs, for both large employers and insurance carriers.

(ii) The majority of workers have group health insurance, and although a tax cap may exempt many from paying tax, an employer must be prepared to establish appropriate records for all employees under the group plan.

A key expense consideration will be the process by which the employer's cost is allocated to each employee. The more equitable the allocation of imputed income is to employees, the more expensive it is likely to be to administer.

(iii) Under the Treasury proposal, the cost of health coverage must be determined in advance of the payroll period. If the actual cost cannot be determined in advance, estimates are to be used. There are penalties on the employer if estimated costs are subsequently found to be not reasonable.

Large fluctuations in group claim experience are not uncommon, and may frequently exceed what the Treasury regards as a reasonable prospective estimate. It is evident that employers are to be subjected to a new chapter in regulatory control and potential financial liability.

(iv) Special adjustments will be necessary for employees who add or drop dependent coverage during the year. Special calculations will be required for newly hired and terminating employees. Expensive changes to electronic data processing systems will likely be required.

(v) The new imputed income will increase all employers' Social Security taxes. This may be especially difficult for the small employer, who will also be pressed by higher bookkeeping costs.

(vi) Special accounting problems may arise in relating an employer's billing premium to true cost determined after the end of a policy year. To the extent that the employer's true cost is less than premiums, through dividends or other credits returned to him, the imputed income to employee should also be reduced, perhaps retroactively. That could entail considerably more complications in accounting and recordkeeping for the employer.

It is ironic that an Administration committed to less regulation and federal reporting requirements should be proposing a tax change that would add extensive new employer administrative duties. It is very likely that many employers will explore the opportunities for legitimate tax avoidance. The incentives are to minimize administrative problems and to spare employees from an inequitable and haphazard tax burden. In addition, union leaders will also be interested in tax avoidance on behalf of their membership.

Tax Avoidance

The general thrust of the tax avoidance arrangements will be to reduce employer contributions to the group health insurance coverage, to eliminate tax liability, and to shift an equivalent amount into benefits which are either completely tax free or at most tax deferred for many years.

An example of the former is increased vacation allowance, while examples of tax deferred benefits are pension plans and company contributions to savings programs.

The particular approach would depend on the amount of contribution to be shifted and other factors such as the distribution among employees of tax liability. Although an employee's contribution to his or her health insurance plan would increase, the tax would have been avoided. The increased tax free or tax deferred benefits will leave the employee in about the same position as before the tax was imposed.

Both large and small groups could implement tax avoidance arrangements, with the aid of in-house expertise or through consulting firms.

Although it is difficult to forecast the extent to which employers and unions will make tax avoidance changes, it is likely that many will. A tax that falls in an inequitable and often haphazard fashion will be difficult for employees to understand and accept.

An employer who can offset an unpopular tax is likely to do so. The result will be that much less tax revenue will be realized by the Treasury.

To illustrate this point, the firm of Price Waterhouse analyzed the Treasury Health Cost Containment Tax Act of 1983. In that proposed legislation, taxes on employee contributions to health benefits were expected to generate $27 billion from 1984 through 1988. According to Price Waterhouse, an equally reasonable assumption was only $6.5 billion. The difference was due to different views of the extent to which taxable health benefits would be shifted to non-taxable benefits, and other factors.

Cost Containment

The rapid acceleration of health care costs in recent years has focused attention on the need for improved cost containment. A current theory is that more effective cost containment would result if there were more competitive marketplace forces at work in the health care industry.

Advocates of the theory wish to encourage insurance plans with reduced benefits and more employee cost sharing. For those covered under such plans, more cost sharing is expected to result in less demand for health services and thus lower prices through greater consumer cost sensitivity. This, in turn, is expected to stimulate competitive reactions from providers and ultimately result in cost containment for all patients.

The present lack of marketplace competition is attributed in large part to the tax free status of employer contributions to health insurance. That is said to have encouraged employees to seek "excessive" amounts of insurance, thus insulating them from significant out-of-pocket expense and making them insensitive to health care costs.

The proposed taxation of health benefits is expected to motivate employees to change to lower premium plans with more cost sharing features, which is thought to be the route to cost containment for all.

The need for improved controls on health care costs is not in dispute. Many employers in recent years have increased deductibles and installed other cost containment provisions in an effort to reduce plan outlays, without the presence of a health benefits tax.

The justification of the proposed tax as a cost containment measure, however, rests upon: (1) a theory that the tax itself will result in significant numbers of employees voluntarily shifting to plans with more cost sharing, and (2) a theory that more cost sharing will actually result in more cost containment for *all* patients. It is important to consider the plausibility of these theories before complex tax legislation, with many adverse impacts, is enacted in the name of cost containment.

Cost Sharing

Let us first consider the likelihood that the tax will result in a significant number of employees voluntarily becoming covered under plans with more cost sharing. The actual number of employees affected by the tax will depend upon the methods of calculating imputed income, the level of the exemption amounts, and the prevalence of tax avoidance arrangements.

It is clear, however, that for those employees who do become liable, the tax would represent an increase in the cost of their insurance. A decision to seek less insurance will vary greatly with the employee's circumstances. These would include the amount of tax involved, a family member's health status, the nature of the reduced benefits in the lower premium plan, and the employee's degree of aversion to the financial risk of medical expenses.

The relative ease with which the employee could change to a lower premium plan is also of importance. In this regard, there are two situations to consider. The first is where a single group health plan is to apply without any choice of insurance plans available. The second is where there would be a legal requirement for an employer to offer at least two conventional insurance plans with different benefit levels.

Employer maintains a single conventional insurance plan

Employers typically offer either a single company wide insurance plan, or a single plan for all employees at a given location or in a specific bargaining unit. If the tax motivates some employees to desire a lower premium plan, they must secure the employer's agreement to change the plan for all employees. If the plan is under collective bargaining, union agreement would be needed as well.

Before agreeing to a plan change for all employees, the employer must be convinced that most employees would willingly accept a plan with a higher deductible or coinsurance or which covered fewer expenses, to satisfy a minority. For most groups, the likelihood of such a change is very low for the following reasons:

(1) Most people tend to be risk averse with regard to health care. The preference for high level health insurance protection reflects a desire to be relieved of financial risk and emotional pressure on the occurrence of accident or sickness. At the end of 1982, approximately 175 million Americans under 65 had one or more forms of coverage under group and individual policies. Over 90% of these persons had major medical protection, which is the broadest form of protection available.

It is doubtful that any significant proportion of employees will voluntarily seek more out-of-pocket exposure to hospital and medical expense, or will wish to have fewer services covered.

(ii) The employer is not likely to change to a lower premium plan to satisfy a minority of employees, and risk resentment from the majority. If collective bargaining is involved, the union leadership would face the same dilemma. A plan with more cost sharing might well be resented by employees who either are not liable for tax or who are being subsidized by other employees by the way the rules are written.

It would be logical to expect that group insured persons would continue to be risk adverse, despite the presence of a new tax. There is little reason to believe, therefore, that any significant number of employees will voluntarily seek less insurance as a result of the tax on employer contributions. Those who do are likely to be attracted only to plans that preserve hospital and surgical coverage at the expense of vision, dental and other ambulatory care benefits.

When the difficult employee relations problems of employers are also considered, we would conclude that few groups are likely to change to lower premium plans on account of health benefit taxation.

Employer offers a choice of two insurance plans

Some proposals imposing the tax on employer contributions have also required employers to offer two insurance plans, one costing less than the other. The employer would probably be required to make the same contribution to each plan, and provide a rebate to an employee if the premium for his plan were less than the employer's contribution.

Under this approach, any employee motivated by the tax to seek a lower premium plan could do so directly. This avoids the problems in changing a single plan that applies to all employees, and could result in more employees becoming covered under plans with more cost sharing features. The choice of plan process, itself, however, will produce severe distortions between the cost of the insurance plans, which will eventually make employee choice meaningless.

The risk averse nature of people described previously will initially limit the number of employees changing to lower premium plans, especially if significant cost sharing of hospital and surgical expense is involved.

Those who do change, however, will be less likely as a class to need medical care in the near future than those who remain in the higher premium plan. That is because some of the employees who might be attracted to the lower premium plan will not change if future medical expenses are anticipated, which is known as adverse selection.

Adverse Selection

Adverse selection, when a choice of plans is available, is a natural consequence of the tendency of employees to act in their own best interests when making their decision. The degree to which it occurs depends upon the benefit differences of the two plans.

Employees that anticipate large impending expenses for elective surgery in the near future will avoid a plan that requires more cost sharing of hospital and surgical expense.

Employees with chronic illnesses, requiring frequent physician office visits and prescription drugs, will avoid a plan with little or no out-of-hospital coverage. It is difficult to control adverse selection without severely limiting in various ways the employees' freedom to choose.

The subsequent effect of adverse selection will be a major distortion in the premiums required for the two insurance plans. At each annual opportunity to change plans, the rearrangement of employees by their medical needs will become more pronounced. The cost of the higher premium plan will increase much more rapidly than will the cost of the lower premium plan, which will force a revision in the way the employer's contribution is computed.

If the contribution were linked to the high premium plan, the employer would soon be faced with much higher *total* contributions. This would be due to the rapidly increasing high premium plan costs, and the requirement to provide rebates to those in the lower premium plan.

In order to control his cost, the employer would most likely set his contribution each year in a manner unrelated to the specific premium for any plan. This would force larger and larger employee contributions under the high benefit plan, as the premium rose faster than the employer contribution.

As a result, even employees who would naturally desire the higher premium plan may feel compelled by high employee contributions to change to the lower premium plan. This could be disastrous for financially pressed lower paid employees who select the low premium plan, and then suffer the expenses of a major illness or accident.

It is also a disaster for less healthy employees in the high premium plan, who pay ever increasing contributions for their coverage. The distortions produced in premium and employee contributions are such that employees will be less and less able to make rational choices with respect to price.

The financial problems and employee discontent engendered would eventually either force a return to a single plan, or a narrowing of the difference

in benefits between the two plans, or a cross-subsidization of the two plans' premiums. The smaller the group involved, the faster the breakdown is likely to come.

Administrative Expense

The requirement to offer two insurance plans would also mean much additional administrative expense for employers. The complications of permitting annual changes and providing rebates will drive up record keeping and electronic data processing expense. Many employers are likely to attempt to minimize this situation through tax avoidance arrangements.

Overall, the tax, together with a choice of plan requirement, might temporarily result in more employees changing to low cost plans. Through the effects of adverse selection, however, the choice of plan structure will eventually break down. The two plan approach would either be abandoned or the plan differences would be narrowed.

Another solution might be to cross-subsidize the two plans, but all of these outcomes are contrary to the original purpose of the two plans. The end result will be few employees covered under low premium plans. The added burdens on employers will make tax avoidance arrangements more attractive.

Two Theories

It was noted earlier that the link between the tax and better cost containment rests upon two theories. The first is that the tax will lead to a significant number of employees becoming insured under lower premium plans with more cost sharing. We have seen that that is not likely to result whether employers have a single plan or provide for employee choice.

The second theory is that greater cost sharing will actually result in more cost containment for *all* patients. Let us consider the likelihood that that will occur.

Persons covered under plans with more cost sharing are expected, through their heightened cost sensitivity, to become more astute buyers of health care services. The average consumer, however, is not equipped to judge whether prescribed medical services are needed, or to shop hospitals and physicians for price value. Furthermore, most often the consumer would lack the emotional composure required to reach an informed decision. These are some of the reasons for the widespread consumer acceptance of comprehensive health insurance.

When persons subject to more cost sharing avoid medical care, there may be longer range impacts on health status that are not presently well understood. More evidence needs to be accumulated to support the view that cost aware consumers can fulfill a marketplace role, without impairing their health in the process.

Under the theory, cost containment will be improved for all patients when hospitals and physicians respond to marketplace pressures and become more efficient and competitive. The marketplace pressures are to be produced by the persons covered under plans with greater cost sharing who will utilize fewer services. Since, however, these persons are expected to be few in number, providers can simply increase fees. Most patients will remain covered by comprehensive insurance, and it will not be difficult to compensate for any income losses from patients with greater cost sharing plans.

In addition, persons with more cost sharing on out-of-hospital benefits may seek hospital admission in order to have diagnostic tests covered. This could drive inpatient costs even higher.

As long as these reactions are possible, the objective of cost containment for all patients through more cost sharing plans is not likely to be achieved. A minority of persons with less insurance coverage, is not likely to induce much provider competition or cost containment.

In summary, the two theories underpinning the justification of the tax as a cost containment measure are not very plausible. Significant numbers of employees will probably not change to plans with more cost sharing. Those who do are not likely to produce the marketplace reactions from providers that will lead to cost containment for all patients. The impact of the tax on cost containment, therefore, is expected to be negligible.

The Need for an Employee Health Benefit Tax Preference

In the preceding sections, we have seen that the major arguments supporting health benefits taxation are fatally flawed. The prospects of rampant inequity, regressive taxation, doubtful revenue, administrative expense and a failure to improve cost containment do not permit serious support for the proposal. Thus far, we have dealt only with the reasons why such taxation would not achieve its purposes. It is appropriate now to discuss the reasons why the tax preference has been historically good public policy and should be maintained.

In our view, tax incentives can be justified if desirable public objectives are achieved through the appropriate response of private enterprise. For many years there have been tax incentives to encourage employers to provide health benefits to employees. We believe that a major public objective has been achieved in that 162 million persons – workers and their families – have one or more forms of group health insurance protection.

Secondly, that achievement has been accomplished by private enterprise, which, through competition in a free economy, has delivered its product to the best advantage of the consumer.

Wisdom of Tax Incentives

We believe the wisdom of the tax incentives has been well proven for the following reasons.

Most Americans today recognize that medical expense insurance is a basic necessity. They realize how reckless it is to risk financial devastation on account of accident or sickness. Adequate health coverage eliminates a major source of fear and uncertainty in people's lives, and provides access to health care services that might otherwise be unaffordable.

The existence of Medicare and Medicaid demonstrates government's commitment to the need for coverage among those for whom public programs are necessary. It is the private sector that has met that same need for the bulk of the population through employee health benefit plans.

The ability of private companies to offer group insurance goes hand in hand with the tax incentives for employers and employees. The relationship can be explained by a brief description of how group insurance is underwritten.

Evidence of Insurability

Under current industry practice, medical expense benefits can be made effective for an employee group *without* individual medical evidence of insurability if at least ten employees are involved. The usual rules only require that the employees enroll when first eligible, and that they be actively at work when coverage is to become effective. Dependents are also covered on a non-medical basis under similar rules.

This liberal approach to offering coverage is of enormous importance to the public, since many persons become group insured who would have difficulty obtaining medically underwritten individual insurance.

Insurance companies can appropriately price group health insurance and maintain acceptable financial experience, despite the absence of evidence of individual insurability. The reason is that a high degree of employee participation in the plan is required.

If the plan is contributory, at least 75% of employees must enroll, and all employees must be covered under non-contributory plans. With these participation requirements, a reasonable cross section of risks is obtained which provides stability to the financial experience. These rules ensure that both young and old employees enroll, and also the healthy as well as those who have medical problems.

There is usually no difficulty in getting employees to enroll, since the value of health coverage is appreciated and the employer pays all or nearly all of the cost of the plan. Furthermore, the employer contribution is not taxable income to the employee.

There is a supportive relationship between tax incentives which encourage employers and employees to participate in group health benefit plans, and the ability of insurers to successfully underwrite such coverage without medical evidence of insurability. This has worked so well that the protection of 162 million Americans under 65 has been accomplished by the private sector without any need for federal intervention.

Additional Cost

If employer contributions to health insurance were to be taxed, participation in the employer's plan would become less attractive to various employees because of the additional cost. As an example, young employees would begin to realize that they are paying more income tax than

they should, as they are subsidizing older workers. With the advantage of young age and good health, such employees could find more competitive health coverage outside the employer's group plan.

As they withdraw and participation falls, the cost of the group plan will rise reflecting the changed spread of risk. Such changes produce sharp premium increases, which in turn encourage more employees to seek more competitive coverage outside the group plan. That further increases the instability and the cycle continues.

Another category of employee that could be forced out of the group plan by the proposed taxation is the low income worker who simply can no longer afford health coverage. That would be especially true of low income workers in the large cities with high medical costs. In that case, the levels of uncompensated hospital and medical care will rise.

When that occurs, providers raise prices to those who pay, which means increased insurance premiums. That, in turn, would mean higher taxes for those who remain under the group plan, and even more incentive for the young and healthy to seek more competitive coverage elsewhere.

Negative Effects

The negative effects of health benefit taxation on group plan participation will increase over time. Under the Treasury plan, the exemption amounts of $70 per month and $175 per month for 1987 would be indexed to the Consumer Price Index in subsequent years. Premium rates, however, normally increase faster than the CPI. That is because they account for changes in both medical prices (which usually increase faster than the overall CPI), and the utilization of medical services.

Over time, therefore, taxable income will increase as a percentage of the employer contribution, despite the indexing of the exemption amounts. There is also a possibility of future reductions in the exemption amounts. As evidence of that, it might be noted that the $50,000 group life insurance exemption has never been increased, and it is now proposed under the Treasury plan to remove the exemption completely.

Overall, the tax will create ever increasing incentives for employees to withdraw from the group plan. The eventual outcome will be a severely restricted ability of insurers to underwrite group health insurance on a non-medical basis, especially for small and mid-size groups.

As a result of weakening the private group insurance mechanism, more and more employees and dependents will encounter difficulty securing adequate coverage at a reasonable price. As the proportion of the population without coverage grows, the incidence of financial ruin on account of accident and sickness will increase, along with levels of uncompensated care in hospitals.

These conditions will bring forth pressures to expand public insurance programs, not withstanding the fact that Medicare and Medicaid now consume a very large share of the federal budget.

The encouragement of health insurance coverage through tax incentives has been enormously successful in terms of social and economic accomplishments. The present system of employment related health benefits was built up over several decades, and works very well. Americans have come to regard employer sponsored health protection almost as an automatic feature of employment, providing benefits of great value.

In our view, no change should be made in tax incentives which might impair the ability of the private sector to provide essential insurance protection to the public. Over the long term, it is our private system of health care delivery that is at stake.

BENEFIT TRUST LIFE INSURANCE COMPANY
CHICAGO, ILLINOIS

RALPH J. ECKERT
CHAIRMAN AND CHIEF EXECUTIVE OFFICER

June 24, 1985

The Honorable Alan J. Dixon
Senate Committee on Small Business
Russell Senate Office Building
Washington, D. C. 20510

Dear Senator Dixon:

Thank you for inviting me to testify June 10, at the Senate Small Business Committee hearing on the taxation of employee benefits.

I am attaching a paper prepared by the Health Insurance Association of America entitled "The Case Against the Taxation of Employee Health Benefits."

Table B on page 6 of this paper, indicates that under Treasury I--(The Tax Cap)--estimated additional taxes for the Chicago area for 1985, ranged from a little under $200 a year to something over $600 a year depending on salary, size of employer and extent of employer contribution. This table does not pretend to be necessarily representative of the whole universe as we do not know the actual distribution of employees by earnings, employer size and employer contribution. However, I would expect that the health insurance plan that we used in the calculation to be quite typical. (Detailed specifications are attached.)

In my opinion, an estimated tax increase of $200 for Chicago has to be the right order of magnitude. Over two-thirds of employers are paying the entire premium according to the survey of new group health insurance. The average earnings of all salaried employees is now in the $20,000 area. While the employer contribution for single employees would be less than the family assumption in the table, single employees are in a higher tax bracket.

A $200 additional tax multiplied by 40 years of working lifetime comes to $8,000 of additional taxes. While employers may make an effort to increase employee cost sharing, this seems to be primarily in response to adverse inflation trends and the result will probably be to keep the employer cost level at best and, therefore, the additional taxable income to employees will remain level and so will the additional tax. The $200 of additional tax is not to high paid employees or even to the average but for those being paid somewhat less than the average.

If you need any further information, please let me know.

Sincerely yours,

Ralph J. Eckert
Chairman and Chief Executive Officer
Benefit Trust Life Insurance Company

RJE/np
attachments

Specifications

Plan: Comprehensive Major Medical (standard product).*

(a) Covered medical expenses:

Hospital room and board charges, semi-private level
All hospital special service charges
Physicians and Surgeons fees
Diagnostic x-ray and laboratory charges
Radiology charges
Prescription drug charges
Private duty nursing fees
Durable medical equipment and prosthetic appliances
Other medical services and supplies

(b) Deductible: $100 calendar year per person; $200 family max. Deductible is front end; i.e. applies to total covered expense.

Coinsurance: 80/20; calendar year limit on out-of-pocket coinsurance is $1,000 per person, $2,000 per family. Deductibles cannot be used to satisy out-of-pocket limit.

Lifetime limit: $1,000,000 (or unlimited)

(c) Maternity: covered same as any other

(d) Newborn: coverage from birth

(e) Limit on ambulatory psychiatric care: large group - 50% coinsurance; small group - 50% coinsurance and $1,000 lifetime max.

(f) Policy year January 1, 1985-December 31, 1985

(g) Show monthly premium rates for areas requested. Show employee only and employee plus flat dependant (i.e. Family). Assume employee is male age 40-44. If rates are subject to change more than once for the policy year, please give the average premium rates you expect for the full policy year.

(h) Cost containment provisions: Include second surgical opinion coverage and policy incentives that encourage the use of ambulatory surgical facilities.

* Small variations from these specifications, that have little effect on premium rates, may be ignored.

Senator DIXON. Professor Resek, you may proceed.

STATEMENT OF ROBERT W. RESEK, PROFESSOR, BUREAU OF ECONOMIC AND BUSINESS RESEARCH, UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Mr. RESEK. I would like to thank you, Senator Dixon, for holding these hearings and the Senate Committee on Small Business. These issues and these hearings are very important to the people of Illinois and to the people of the Nation. This is, indeed, a very important question that you are looking into. All of us are grateful to you for doing it.

The work that I did in preparing this material was done in association with a research assistant at the University of Illinois, Mr. David Lee. He is sitting over here. Raise your hand.

[Mr. Lee raises his hand.]

Mr. RESEK. I want to thank him, too, for participating in helping us prepare the materials that we have here.

Fringe benefits are exceedingly important to the people of the Nation. I have a number of charts, and I will refer to them. They are in my written testimony.

Senator DIXON. I have them here.

Mr. RESEK. OK. In chart 1 you can see that there are a great number of employees with employer- or union-provided health care benefits. Indeed, there are something like 63 million employees who are so covered at the present time, including those that have all or part of their care covered. It involves a very large number of people, and that makes it important to all of us.

In the second chart you can see also fringe benefit plans involve a very large sum of money. Indeed, in 1982 the total that we found of employer contributions to group health and life plans totaled something on the order of $73 billion. The volume of money associated with this makes the issue exceedingly important and an issue that can't be lightly put aside.

I would like to talk for a moment about the criteria that I think are important in judging fringe benefit plans. These are the natural criteria that you have already talked about in your discussion here.

First of all, we have the question of fairness. All workers in similar economic circumstances should receive the same tax treatment regardless of the specific characteristics of the firm or the industry in which they are employed. That is a kind of principle most of us can agree with.

Senator DIXON. True.

Mr. RESEK. This kind of fairness should extend across firms of different sizes. It should extend for different firms of different ages or different longevity, for new firms and old firms, and it should extend for firms in different kinds of industry groupings. Therefore, there are a number of the kinds of things that we have to consider in judging fairness.

Second, efficiency and the American system and the efficient operation of our economic system are important to us. We want to have a tax system that encourages the American economy to move

forward and not to have the Government muck up the works, and throw levers, and so forth into the crankshaft.

Senator DIXON. At least not any more than we do now.

Mr. RESEK. That's right. [Laughter.]

The tax structure should aid the economic system in working efficiently. The Government should intervene in the workings of the market only where issues such as monopoly or controls from outside or external effects or pollution issues, and so forth, alter the ability of the economic system to perform. This implies that prices of all commodities should indicate the true economic cost of the product or service. The very nature of our system means that the prices themselves, being determined in what amounts to competitive markets, are the driver of the efficient market system, and the freedom of those prices to be set appropriately by that system is very crucial to us. That has to be an issue that is considered as we discuss and consider fringe benefits.

Third, we want to consider simplicity. This you have mentioned and we all mention. Simplicity is very important. The people of the United States will accept a tax system more if they understand it and they will have a better feeling about the Government if they have a simple system. We all understand that. I think simplicity is less important than the question of fairness and efficiency, but it is an important issue.

Senator DIXON. I might interrupt at that point to say that sometimes in attempting to find simplicity we kill fairness and equity.

Mr. RESEK. Absolutely.

Senator DIXON. I was talking before with Mr. Eckert. Apparently you are not following your text exactly, so I can interrupt if you don't mind.

Mr. RESEK. That's right.

Senator DIXON. Like on the hospital system in the country, this administration wants to move now to a national rate, don't you see, which is incredibly unfair to Illinois. I have a bill in right now to try to prevent them from doing that. It would cost Illinois hospitals $200 million next year to go to a national system. Why? Well, when you take the same sum and spread it over the country, we are a high-cost region, and North Dakota is a low-cost region. Incredibly, we find so often—and I don't mean this necessarily in a partisan way but sometimes when this administration goes for simplicity, as it continues to do with these things, what it does is the Californias, the New Yorks, the Illinoises, the Pennsylvanias, the Michigans, the Ohios of this country get killed.

Mr. RESEK. I agree, but I disagree right off. Clearly, the fairness and efficiency are very important, but it is also clear that firms and industries in Illinois ought to be able to compete with the firms and industries of North Dakota. I don't believe that Illinois is by its very nature less efficient and less effective in operating its economic systems than other States.

Senator DIXON. You believe the health care costs are higher here in Illinois than in North Dakota, though, don't you?

Mr. RESEK. I don't believe they should be.

Senator DIXON. I see.

Mr. RESEK. I think that in the longer run we ought to have a system where we can provide health care at reasonable cost and

that the health care industry ought to be fairly operated in that sense. I question whether it is desirable for us to have discrimination against North Dakota in favor of Illinois even though I am a permanent resident and have always lived in Illinois.

I will go on. The fourth issue that I think is important, as we discuss this here, and this is not a principle as much as a discussion issue, is constant revenue. That is, it is not right to talk about fringe benefits both in terms of their equity and fairness and in terms of their ability to generateing revenue. I want my discussion to focus on how we deal with fringe benefits and keep the revenue constant, and not how we can generate revenue from fringe benefit changes. I think we have to devise systems which retain the fairness without talking about generating revenue.

The current status in terms of small and large businesses is shown in chart 3 of my paper. This shows the percentage of employees covered by group health benefit coverage for union and nonunion firms and for large, medium, and small firms, and the data are from prior Senate hearings on another topic.

The crucial point that this chart makes is that those firms that are organized by unions have slightly higher coverage levels than those that are not organized. Although the difference is relatively small, it shows the effectiveness of the unions in accomplishing their appropriate goals.

In addition, it shows that small firms have a substantially lower level of coverage than do large firms. This was mentioned in testimony of Mr. Eckert. He indicated that small firms do have less coverage than large firms. Indeed, it is a very substantially smaller level of coverage. That is the issue that affects us on the question of small business.

The lower level of coverage within small businesses makes a great deal of difference, and we have to insure that the coverage and the taxation treatment of employees and employers who are in small businesses are treated equitably despite their choices as to how they choose to receive the total set of benefits that they receive from the business.

Senator DIXON. May I interrupt at that point?

Mr. RESEK. Yes.

Senator DIXON. Understand I am trying to be the devil's advocate here——

Mr. RESEK. Sure.

Senator DIXON [continuing]. Because we want the record to teach us some things as we go along.

What about Mr. Moats' point again? Of course, I come here with a full understanding that each of you feels that we ought not to put the foot in the door. I have sympathy for that point of view, but if it is not the thing that prevails in the Congress, isn't it a fact that some variant of Treasury I on this issue is better than Treasury II from the standpoint of the ordinary working person?

Mr. RESEK. Absolutely. I was going to come to that. The question of efficiency—I might as well say it now since you asked—the question of efficiency, and here I think I would disagree with Mr. Eckert rather substantially—means that the last dollar that we pay for health care costs ought to represent the true cost of the health care we receive. In our economic system we wish to have

everybody pay the correct cost to our society for health care, for clothes for their children, for education for their children, and for other goods that they buy. We may choose to have social programs that aid the health care industry, and those are appropriate issues to be discussed, but we ought to be careful about mixing those issues with the question of how people receive their pay and fringe benefits. Maybe we ought to separate the question of subsidy of health care issues from the question of how we deal with fringe benefits.

An economist will always tell you that you ought to pay the fair cost, and that means that Treasury I is a much better plan that the latest plan. The latest plan does all the wrong things. It taxes the people. It taxes the lower income people.

Senator DIXON. That's right.

Mr. RESEK. It taxes them at higher——

Senator DIXON. And it brings in half as much money. I might observe that you could modify—of course, you would understand this very readily—you could modify Treasury I and increase the cap substantially to make that incremental difference and get the same revenue yield by substantial increases in caps in Treasury I that you get by turning around and taxing the very poor, as you do in Treasury II.

Mr. RESEK. I might add you could even carry this farther——

Senator DIXON. I see Mr. Eckert getting nervous. I am not advocating these things; I am just stating what is a fact. [Laughter.]

Mr. RESEK. I would say this: I would take it one step farther. The lower income person gets lower benefit from the cap or from any of these deductions than does a high-income person because the high-income person in the 35 percent bracket gets 35 percent back——

Senator DIXON. Sure.

Mr. RESEK [continuing]. Out of the amount of money that goes into the health care plan. The lower income person who is in the 15-percent bracket only gets 15 percent back. The tax benefit is more than twice as much for the high-income person than for the lowincome person in terms of buying health care coverage. You would be better off having a tax credit whereby you gave some kind of a particular tax credit in association with the health care he buys, and that will do more good for the low-income person than will the deduction. It would also insure, because it would be a limited amount, that they paid the fair cost for their coverage that they received, and it would not give a greater benefit to the higher-income person than the low-income person.

Senator DIXON. Have you done the math on this, Professor Resek? For instance, I would be interested in what the categories—I mean, what the caps could be to get approximately the same revenue result with Treasury I modified as you get with Treasury II. Does anybody know that or has anybody done that?

Mr. RESEK. I will do that and I will write you a letter.

Senator DIXON. I would be very pleased to have that because, while I don't advocate any taxing of fringe benefits, my vote would—if we are given this choice—on the Senate floor we sometimes have these choices, unlike the House where they very seldom do have those alternative choices. If we had the choice, I would be against taxing the fringe benefits. But if it comes down to a final

bill where it is a vote for tax simplification or against it and this is in it, I would at least like to have it in there in a way that is fair to the ordinary working man and woman in America. I am absolutely persuaded that Treasury I modified would do a better job of that than Treasury II.

Mr. RESEK. That is absolutely correct; it would. I will write you a letter telling you my estimate of the amounts of money that would do that.

Senator DIXON. I would be pleased to have that.

[Subsequent information was received and follows:]

University of Illinois at Urbana-Champaign

BUREAU OF ECONOMIC AND BUSINESS RESEARCH
428 Commerce Building (West)
1206 South Sixth Street
Champaign, Illinois 61820
(217) 333 2330

June 13, 1985

Karyl Arnold
316 Hart Senate Building
Washington, DC 20510

Dear Karyl:

I found the hearings on Monday to be interesting and useful. I was pleased to have the opportunity to attend. Enclosed is the additional statement which I indicated I would send. Note that if there is a fringe benefit level of $100 per month per person or $250 per month per family, that the revenues will be comparable to the Treasury two level.

Sincerely,

Robert W. Resek
Director

RWR:bck

Enclosure

University of Illinois at Urbana-Champaign

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ADDITIONAL FACTS ABOUT FRINGE BENEFITS.

Robert W. Resek and David Lee

June 12, 1985

Fringe Benefit Cap - Treasury I.

There is a cap on the maximum amount of employer provided health insurance that is free of taxation. The amount free of tax is $70 per individual per month or $175 per family per month. "The proposed limits would have no effect on approximately 70% of all employees because the limits exceed their employers contributions." (Treasury I, pg. 73). All proposals indicated here are indexed by the CPI.

Revenue projections for Fringe Benefit Cap.

Limits of taxation - $70 / $175 per month per person / family.

Fiscal year	Billion dollars Revenue*
1986	-
1987	4.6
1988	8.0
1989	9.8
1990	11.9

* This revenue projections are based on earlier data than now available and are about 20% too high according to a Treasury Department Researcher.

Fringe Benefit Floor - Treasury II.

This proposal provides an initial amount of employer paid health insurance that is subject to tax with subsequent amounts tax free. (A fringe benefit floor.) The taxable amount is $10 per month per person or $25 per month per family. Since almost 90% of all employees receive employer paid health insurance benefits, all of these individuals would be subject to the tax. In particular it would increase the taxable income levels over Treasury I for the approximately 60% of all employees who have the benefit but are below the upper limits set by Treasury I.

Revenue projections for Fringe Benefit Floor.

Limits of taxation - $10 / $25 per month per person / family.

Fiscal year	Billion dollars Revenue
1986	2.4
1987	3.5
1988	3.7
1989	3.8
1990	4.0

Fringe Benefit Cap with Treasury II Revenue Levels

In the hearings in Chicago on June 10, 1985, we were asked to provide estimates of the cap needed in the form of Treasury I which would provide revenue similar to Treasury II. Phone conversations with the staff of the Office of Tax Analysis of the Treasury Department provided the following information.

Revenue projections for Fringe Benefit Cap.

Limits of taxation - $100 / $250 per month per person / family.

Fiscal year	Billion dollars Revenue
1986	-
1987	1.7
1988	2.9
1989	3.5
1990	4.0

These revenue values are similar to those of the floor indicated under Treasury II above and are equal in the last year. Therefore the substitution of the Treasury I type fringe plan with the caps of $100 / $250 will yield approximately the correct level of revenue.

Typical Level of Fringe Benefits

We were also asked to determine the typical level of health insurance benefits received by employees in the United States. The Treasury Department provides a table of "Distribution of Employer Contributions for Health Insurance (1983), and Estimated Impact of the Proposal." (Treasury II, p. 29). This table indicates that the average employer contribution for all families is $125 per month.

Sources:

Treasury I: Tax Reform for Fairness, Simplicity, and Economic Growth, Office of the Secretary, Department of the Treasury, November 1984.

Treasury II: The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 1985.

Senator Dixon. Now let me ask you another thing. Is this possible as well, Professor, and perhaps Mr. Eckert could help? Would it be possible for us to know what a standard, modest health package is? Does that sound silly when you hear it from the Chair here?

That is to say, what does the average worker enjoy in a standard health policy—that he or she has that would be considered relatively standard in the country—and how much does that cost a month?

Mr. RESEK. We took a number of $900 in what we did for an annual cost. I don't know that that is a representative health care cost, but we found in some book a figure of $900——

Senator DIXON. If I could get something like that, it would be helpful: Numbers on a per-day hospital, what is the deductible on the doctor, and all those things that are part of the general plan. I presume there must be something akin to a standard plan in the country. I would be very interested in knowing—if you could do that for me, Mr. Eckert, as an expert——

Mr. ECKERT. I am sure we can get some statistics for you.

Senator DIXON [continuing]. Possibly supply that to us, and we would place it in the record. What is thought of as a kind of—for instance, my daughter just went to work, and I was paying for her insurance. I checked now and her company says, "Yes, she has insurance." I don't even know what kind, but I presume that generally people have a kind of standard type that one would generally expect to enjoy. It would be interesting for the record to have that and how much it costs, so that when we look at that against what a modified Treasury I would be, we would have some idea how much was excluded from taxing altogether.

Mr. RESEK. All right. I will get you some numbers that I will find from some Federal statistics that actually seem to represent that sort of thing.

[Subsequent information was received and follows:]

TYPICAL LEVEL OF FRINGE BENEFITS

We were also asked to determine the typical level of health insurance benefits received by employees in the United States. The Treasury Department provides a table of "Distribution of Employer Contributions for Health Insurance (1983), and Estimated Impact of the Proposal." (Treasury II, p. 29). This table indicates that the average employer contribution for all families is $125 per month.

Mr. RESEK. Let me go on. I suggest you should consider two separate individuals, one who has a fringe benefit plan and one who does not. The one might be representative of a small business firm just coming into business where the fringe benefit plan has not come into existence yet. It is a new business; it doesn't have a fringe benefit plan.

Of the two individuals, one earns $25,000 a year and has $900 worth of fringe benefits. Under the Treasury plan his total taxes would be $3,515. If you took a similar individual in a firm that did not have the fringe benefit plan and for which the company paid the same total amount of money, the firm would have to pay him $25,900 because they are giving him $900 worth of fringe benefits. His taxes would be higher. They would be $3,740. Therefore, the person in the firm without fringe benefits will pay $225 more in taxes than the person in the firm that does have the fringe bene-

fits. This is an inequity to this person because he happens to be in a firm that doesn't have these benefits.

What are the costs in benefits, therefore, of the fringe benefit plans as they exist for these two individuals? If you have a fringe benefit plan, the losers are the employees with no fringe benefits because ultimately their final take-home pay plus benefits after taxes is $225 less than the person in the firm that does have a plan.

Second, the small business firm is disadvantaged. It is disadvantaged because it is paying the same amount of money in worker compensation but the worker gets less after taxes. The quality of worker this firm is going to get will be less because the employees get less money. The fact is the benefit to the firm is in terms of the quality of the people; the quality of the people is the value of the benefits they receive, hopefully, in a competitive society. The small business firm that has not had the opportunity to set into motion fringe benefit plans--and we have already heard about the high administrative costs and so forth—would be disadvantaged.

Therefore, the existence of deduction of fringe benefits is a major disadvantage to small business firms because it means they cannot get in the market and get an equal quality employee for the same amount of compensation.

Third, there are major efficiency losses from the existence of the fringe benefit plans, and this is what I mentioned before. We want the cost of life insurance and health insurance and stock benefit plans in terms of their real social cost to be the same as the cost of clothes on the child's back and the education for your children, and the other goods you buy. We want those to be determined fairly in the system.

One would expect people from an insurance company, and so forth, to argue in favor of the fringe benefit plans because the deduction makes their commodity cost less. It is in their interest, and it will cause people to buy more life insurance, more stock benefit plans, and perhaps more health insurance than they would otherwise purchase.

Economists would say that society works best when people make their own choices and these choices are made in light of the true cost.

I earlier mentioned that it is the private sector that is providing this. Well, in some sense, health insurance is not provided by the private sector solely; it is provided by the private sector plus a subsidy from the Government in the fringe benefit deductions.

What are the benefits from the fringe benefit deductions? We have talked about those. There are social benefits from fringe benefits in terms of subsidization of health insurance plans, and we understand the social benefits of helping people buy health insurance. We also have subsidization of life insurance and the other fringe benefits.

We would argue that the subsidies would be for limited amounts. They should have caps, if you have them, and they are better as tax credits and so forth. We also argue that subsidies should be on their own merit and not hidden in the fringe benefit law.

We propose that we have a change, and we provide a specific proposal of change. We would propose that you would eliminate all de-

ductions for fringe benefits. This would raise taxes for a substantial number of people and it would raise the revenue for the Government, if it took place. However, we want our proposal to be revenue neutral.

We would take all of the revenue relief from this and return it to the similar income group from which it came, and we propose that this be done by lowering the marginal tax rate for the lowest income groups, for $2,900 to $18,000. By our calculations, you could lower that marginal rate from 15 percent to 13.9 percent. By doing this, all of the taxes for everybody in the United States in that income group would be reduced by that amount of money.

Senator DIXON. You are not talking about an extra category? You are only talking about dropping the low category from 15 to 13.9? Is that what you are saying?

Mr. RESEK. That's all. I would have no deduction on fringe benefits at all. If you go to my chart 5, you will find that there are two lines there. The upper line is the solid line. It would show the tax rates that I propose prior to that change, and the dash lines are the tax rates that I propose after the change. It would lower the tax rates—the total tax paid by everybody earning over $18,000—by exactly the same amount of money, and it would lower the taxes for people below $18,000 by a varying sum of money, because the tax rate was reduced from 15 percent to 13.9 percent.

That would return those funds to those individuals who are the beneficiaries of the fringe benefit plans. I would suggest this is basically returning the money to the people in the category that we want to help. We are helping the people in the low- and middle-income groups by the reduction of the taxes. Rates can be reduced more if we eliminate the fringe benefit plans, and at the same time have the benefits that accrue because of the competitive system.

If you go to my chart 6, you will see the net effects before and after these changes. The before is over on the righthand side of the chart. The people who have fringe benefits in this system would be paying taxes, and their total taxes beforehand—I will find the number here in a moment—would be $3,515. The people without fringe benefit plans would be paying—that is the far right bar—$3,740 in taxes.

After the change I propose, both of these individuals would pay exactly the same taxes regardless of whether they had fringe benefits or not. They would pay $3,573.

The change I propose would raise taxes moderately for those individuals who now receive fringe benefits—about $60 a year—and would lower them substantially for those who do not. This would have the substantial benefit of aiding those small firms coming into business that have not yet developed fringe benefit plans. It would avoid the need to go through the administrative cost of fringe benefits. It would have efficiency benefits to our society, and I think you could construct it in a way so that it would help the group of people that we want to help through the fringe benefit plans.

Senator DIXON. Thank you very much.

[The prepared statement of Mr. Resek follows:]

Small Business and the Taxation of Fringe Benefits

Robert W. Resek and David Lee
Bureau of Economic and Business Research
University of Illinois at Urbana-Champaign

Introduction

This short paper deals with the interplay of several issues of importance to our society and its people. First we are concerned with small business and the actions the government can take or refrain from taking in order to give small businesses the opportunity they deserve to succeed.

Second, we deal with the tax structure in the United States. The government is going through a major program of revisions of the entire federal tax system and some proposals for reform are likely to have a significant effect on our business system.

Third and most critically, we focus on the taxation of fringe benefits. At present many fringe benefits are not included as taxable income by the individual when they are paid directly by the employer. Some of the recent tax proposals would significantly alter this tax treatment and it is our hope to provide some insight into the gains and losses from these proposed changes.

Criteria for Judgment and Assumptions

First we lay out the issues that are before us and our criteria for judging potential changes in the tax structure as it concerns the nature of taxation of fringe benefits. We will then ask how these changes will affect both the ability of our economy to operate effectively, and the degree of fairness that would be

gained or lost through those changes. Moreover, we will prefer a simple tax structure to one that is more complex.

In an economy overshadowed by large budget deficits, one is tempted to consider the levels of taxes and to think about ways that tax revenue may be increased. However, this is not the issue before us at the present time. Our question is solely the desirability of the specific tax rules apart from the revenue issue. Therefore, we will design our study to leave revenue levels totally unchanged. The crucial issues to be discussed when considering changes to the tax system are fairness and efficiency. We turn now to these questions.

FAIRNESS

How do we judge fairness? Fairness implies that all workers with similar economic circumstances receive the same tax treatment regardless of the specific characteristics of the firm or industry in which they are employed. One factor that should have no impact on tax liability is the size of the firm. As a nation, we are concerned with small business and its ability to succeed in our economy. However, we also feel that the government should not bias its laws either for or against the small businesses. Each firm regardless of size should have the opportunity to compete on an equal basis with its rivals and all workers should have equal treatment under the law.

Another factor is the industry group of the firm. Different industries have grown up under different economic conditions and have developed different patterns of fringe benefits and other traditions. Equitable and efficient tax laws should not favor

one particular set of institutional arrangements over another

Finally, unions are an important element in our work place They have and will continue to be an important factor for many workers and many industries Any proposed changes to the tax code should insure equal treatment for workers in firms or industries that are unionized or are not unionized

Clearly other factors do affect the equitable level of taxes We believe in differential taxes for people in different income classes and we will attempt to maintain in our analysis the progressive structure

EFFICIENCY

The tax structure should aid the economic system in working efficiently The tried and true lessons of the American system, and the same lessons in economic theory, tell us that the price system helps the society allocate resources such as land and labor to the uses where they do the most to help the society The government should only intervene in the workings of the market where monopoly, controls or external effects alter the ability of the economic system to perform On the other hand, actions by the government should not be the cause of a change in the relative prices that workers or companies pay for goods and services in markets where there is no impediment to the price system

Economic theory and our own experience in the world tells us that prices should not be altered by government interference except where there is clear market failure The inability of the Soviet Union to get its economy moving is highly related to the inability of a planned economy to efficiently allocate the

resources that are available. In light of this, we should insure that we do not undertake government actions that move resources in ways that reduce the economic performance of our nation.

This emphasis on efficiency is particularly relevant in discussions of small business. Our small businesses are a major force in the betterment of our society and their ability to succeed depends critically on their ability to compete fairly. Therefore, we will seek a tax system that does not alter the basic competitive forces that enable small business to succeed.

Our nation is moving to an economy based more and more on high technology and the development of that technology has come largely through innovations by entrepreneurs. The history of the United States shows that prosperity has come precisely because these same entrepreneurs came to the United States and had the freedom and environment where they could pursue their ideas. In these changing times we must continue to insure that our entrepreneurs are given every fair chance to succeed with their dreams.

SIMPLICITY

The people in our society should support the tax system and one factor that will help build this support is understanding. The current system has undergone a great deal of criticism in part because it is difficult for many people to comprehend. Therefore, it is desirable to achieve a tax system that is as uncomplicated as possible for with this will come increased understanding, compliance, and support. While simplicity is desirable, we feel it is of a lower order of importance than fairness and efficiency.

Constant Revenue

How do we analyze this problem while avoiding questions of revenue gain or revenue loss? We will consider changes in the specific treatment of fringe benefits but will accompany each change in our analysis by a simultaneous change in the rate structure so that the total amount of taxes collected will remain neutral. For example, an increase in the possible deductions will reduce taxable income and therefore reduce revenue. To maintain constant revenue, we must have a parallel increase in the tax rates on that class of tax payers. Similarly, a decrease in possible deductions will be considered in concert with a reduction in tax rates.

Importance of Plans

A very large fraction of workers are covered by some type of fringe benefit plan. Chart I shows the number of employees covered by health care benefits. In 1983 we can see that over 63 million employees had part or all of their health care benefits paid by their employer or union. Moreover, Chart II shows that the total employer contributions to group health and life plans in 1982 totalled 73 billion dollars. The magnitude of these plans both to the individual workers and to the areas of our economy that receives these funds are exceedingly important.

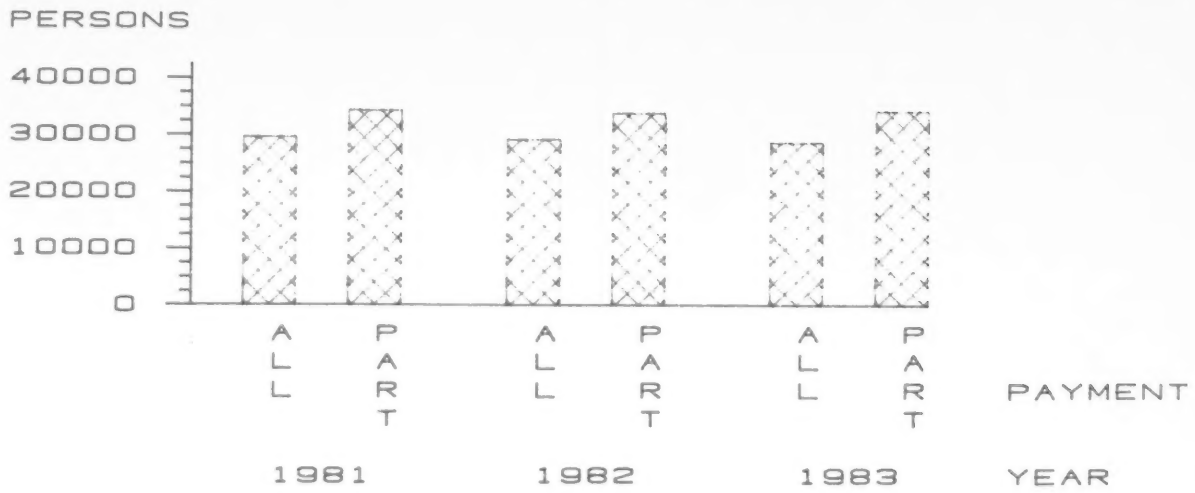
Coverage of Plans

The coverage of plans differs greatly from firm to firm. Chart III shows the percent of employees in group health plans by type of firm. These particular statistics are presented because they are reliable and readily available. The chart shows percent

CHART I

EMPLOYEES WITH EMPLOYER OR UNION PROVIDED HEALTH CARE BENEFITS

(THOUSANDS OF PERSONS)



(PAYMENT REFERS TO EMPLOYER OR UNION)
(CONTRIBUTION TO BENEFIT)

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CHART II

EMPLOYER CONTRIBUTIONS TO GROUP HEALTH AND LIFE PLANS

(MILLIONS)

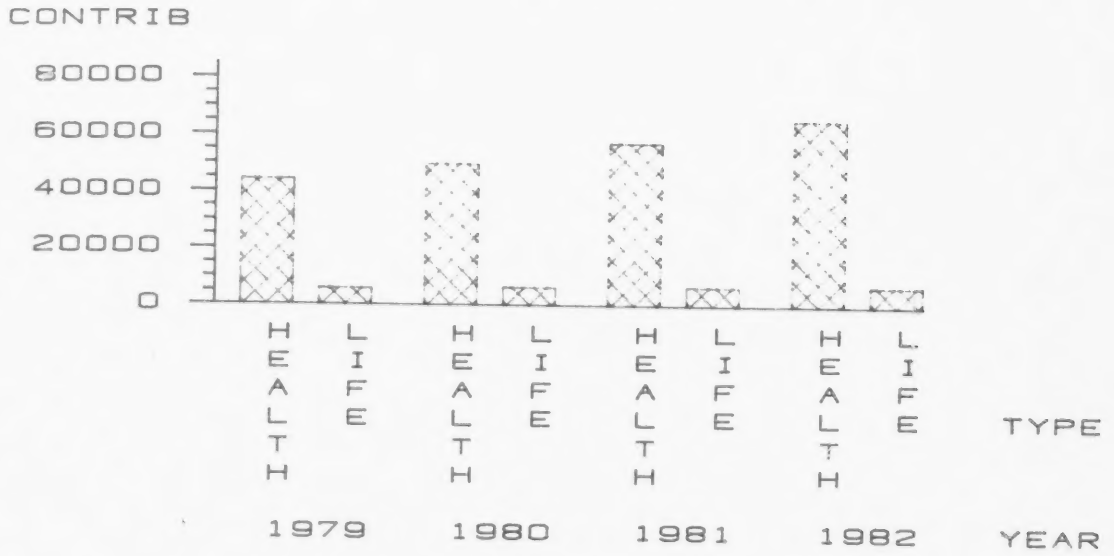

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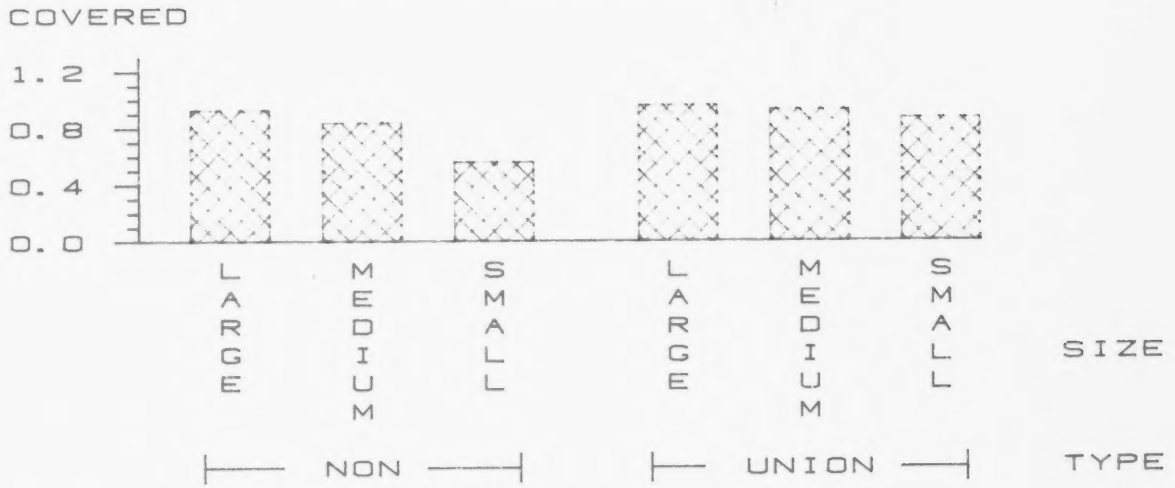
CHART III

GROUP HEALTH BENEFIT COVERAGE

PERCENT OF EMPLOYEES BY FIRM SIZE



SMALL = 0–100 EMPLOYEES
MEDIUM = 100–499 EMPLOYEES
LARGE = OVER 500 EMPLOYEES

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of employees covered by the size of firms and by the union or non union status of the workers.

First, we note that unionized firms on the average have stronger benefits. This to some degree shows the effectiveness of the union leaders in bargaining on behalf of the workers. In fact, 91 percent of workers covered by a union contract have health insurance against just 67 percent of workers without that contract.

Next, workers in large firms are much more likely to covered by health benefits than those in small firms. Indeed, 94 percent of workers in firms with more than 500 employees are covered whereas only 62 percent in firms with fewer than 100 employees receive those benefits.

Analysis

Many types of fringe benefits exist ranging from medical insurance through life insurance to stock option and cafeteria plans. It is not our goal to consider the relative merits of each of these plans. Instead, we will consider benefits as a whole rather than looking at a specific type of plan.

Our analysis is also illustrative in nature rather than being statistically representative of every detail of either fringe benefits or the current or proposed tax system. The numbers below are taken to fairly represent the implications of the tax system and with our assumptions about taxes and the individuals are clearly set forth. However, there will be specific characteristics of the tax plan which may alter the exact numbers - but they will not alter the character and implications of the results we set forth.

We will examine the tax system for two individuals, one covered by fringes and one not covered. Our typical employee working in a firm providing fringe benefits earns $25,000 per year and has a benefit package to which his employer contributes $900 per year. We assume he has exemptions of $2000 and pays taxes on $23,000. Under the proposed tax system, he is in the 25% bracket and pays a total tax of $3515. His annual income less taxes is $21,485 while the value of his pay plus fringes is $22,385. This latter value is the true value of the job to this person.

Our individual with no fringe benefits receives the same total value of pay and benefits as the individual considered above but it is all in wages or salaries. Therefore his pretax income is $25,900 per year. Using the same deduction, his taxable income is $23,900 from which $3740 in taxes are paid in the 25% bracket leaving a disposable income of $22,160.

It is clear that the two firms have the same total employment cost for these two workers. Yet the worker without the fringe benefit package receives $225 less purchasing power per year than does the worker in the firm with the benefits. This is clearly unfair both to the uncovered worker and to the firm that pays him.

COSTS AND BENEFITS OF THE FRINGE PLANS

First, we ask why firms pay these fringe benefits. In part it is because the workers prefer fringes. But even more it is because the use of fringe benefits allows the firm to gain an advantage over firms that do not use these plans. The advantage

arises from the nontaxable nature of fringe benefits which provides a subsidy to workers who receive fringe benefits. But the gain is not free. The net subsidy is a transfer from the workers who are not covered by fringe benefits to those that are

Next, we ask the question of economic efficiency. Do these benefits have an impact on the ability of our economy to perform well? The answer is clear. The firms that include fringe benefits as part of their employee compensation packages get the same worker for less net cost that those that do not pay fringe benefits. Recognizing a higher real return on their labor efforts, workers will transfer from the firms without coverage, say the small entrepreneurial firms, to the firms that do have coverage. These firms, that are on the average larger, have an unfair advantage in the market for workers which results in a competitive advantage in the final product market.

What social benefits might accrue from the utilization of fringe benefits as part of an employees total compensation? Clearly we can argue that health care is important to our society. We may choose to have a way to subsidize the health care industry in order that all people in our society are assured of good care. Similarly, we may decide to subsidize life insurance plans or stock option plans for employees.

Economic theory suggests that these subsidies should be made on their own merits and not hidden in some alternative plans. If we are to subsidize health plans, it should be as a direct tax credit for a fixed amount of health expense. A subsidy in this form would allow people to purchase a health plan of their own choice for at least the amount of the credit. In addition, a tax

credit has an equal effect across all income levels as opposed to a deduction which favors those with higher income.

Economics also tells us that all people should pay the real marginal (additional) costs of their health care. This forces the health care industry to act competitively and demonstrate the benefits it provides policy holders. If a consumer does not pay the last dollar of the insurance plan either directly or through his deduction, then he will not be careful to insure that the plan is spending the funds wisely.

Who benefits from the deduction of fringe benefits? The greatest benefits are received by the firms that offer fringe benefit plans because their true labor costs are lowered. Second, the covered workers benefit for they receive health insurance at a price below its true social cost.

Labor unions realize a very large benefit from the deductions. Since their membership is largely covered, union workers receive the economic advantages while workers in non union industries are losers. This is an unfair bias in favor of the unions.

Lastly, the health care industry and insurance industry both benefit greatly. Economics tells us that different commodities should not be subsidized. Yet health and life insurance under these employee fringe benefit plans are paid in part by the government. This subsidy lowers the price of these services and causes workers to buy more health and life insurance than they would if the deduction did not exist. While insurance is an important commodity, it is not clearly preferable for this money

to spent on insurance rather than on clothes or education for the worker's family or on other goods. If this deduction is removed, the effective price of insurance will rise to its true value and the large insurance industry in the United States will lose business over a number of years and will have to compete more intensively for the business they do get.

Similarly, more competition will come to the health care business. One HMO in Urbana just announced that they are not increasing the cost of service next year. We are obviously pleased about this - but it largely arises because dependent health care is not covered by our employer the University of Illinois. That is, the HMO faces real customers who consider the cost of the service in a real way. If all of the health care were taxed, then all of the health care providers would face this very healthy market in an important way.

Proposed Changes

From the considerations above, we see that there are real elements of unfairness and inefficiency in the current deduction of fringe benefits from taxes. We propose that the tax laws be changed so that the deduction for fringe benefits is removed and the tax revenue gains to the government be given directly back to the class of individuals from which the revenue was generated. That is, the revenue increase realised from workers earning around $25,000 should be directly returned to workers in that same income group. The only change is that income from workers employed in firms without fringe benefits would have the same positive tax benefits as those from firms that do pay fringe benefits.

Consider the two workers we discussed earlier. Our statistics show that in total 73% of all workers are covered by fringe benefit plans and 27% of workers are not covered. We use this fraction to compute the revenue gains from eliminating the deduction. Obviously, the exact gains and method of distributing them must be more complex than the rules we outline, but the ideas and general magnitude will be correct.

After the deduction is removed, the total tax collected in our example rises by $165. We must now give this revenue back to the taxpayers. Our proposal is to reduce the marginal rate in the first tax bracket from 15% to 13.9%. Chart IV shows the tax rates and tax levels under the government proposal. Chart V presents the same information and adds one line which shows the lower tax rates for all tax payers. Under our proposal, the taxes of workers with fringes would rise because, in fairness, his fringe income is included in his tax base which has been the case of the worker from the small firm all along. Our calculations show that his tax rises from $3515 to $3573 or an increase of $58.

The real difference is to the individual not receiving fringe benefits. His tax liability would fall from $3740 to $3573 or a reduction of $167. Because this is typically a non union person and the result is less purchase of insurance, he won't have too many defenders at this hearing.

This proposal would do a great deal to bring more fairness and efficiency to our tax system - and the true cost to the current workers would be small indeed. Most of all this change

CHART IV

TAX LIABILITY

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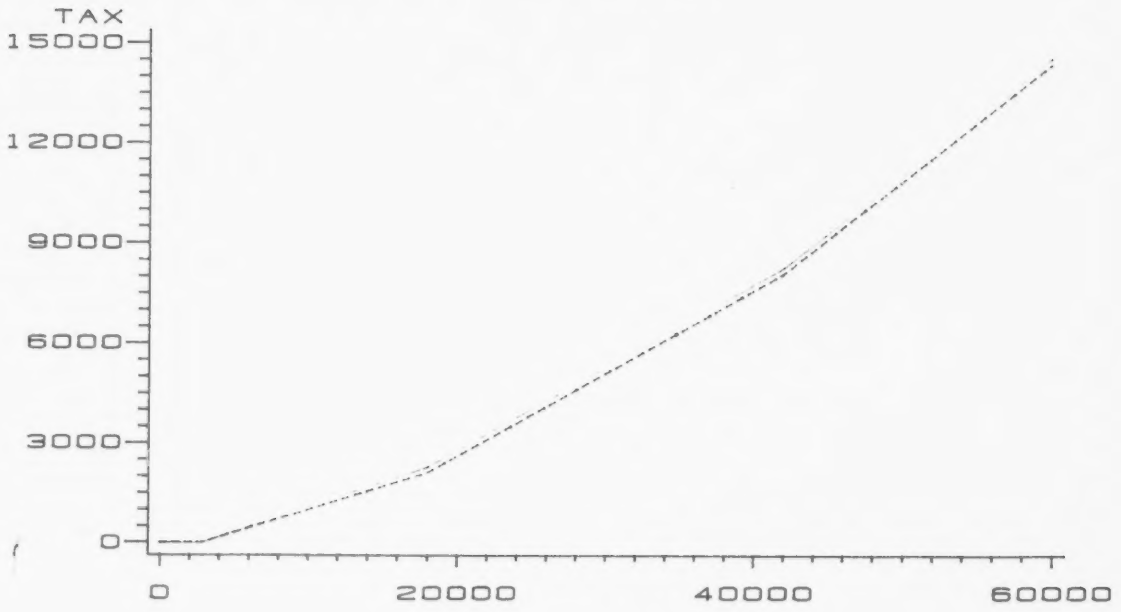
CHART V

TAX LIABILITY



SOLID = REAGAN PROPOSAL
DASHED = OUR PROPOSAL

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CHART VI

TAX EFFECTS OF FRINGE BENEFITS

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would bring simplicity and understanding to our system.

Sources

Chart I: "Characteristics of Households and Persons Receiving Selected Noncash Benefits: 1983," Table 17, Current Population Reports, Series P-60, No. 148, U. S. Department of Commerce, Bureau of the Census, 1985.

Chart II: National Income and Product Accounts of the U.S., Table 6.13, Survey of Current Business, U. S. Department of Commerce, Bureau of Economic Analysis.

Chart III: "Health Benefits: Loss Due to Unemployment," U. S. Senate Committee on Unemployment," April, 1983. p. 3.

Chart IV: Office of the Secretary of the Treasury.

Chart V: Office of the Secretary of the Treasury, Bureau of Economic and Business Research, University of Illinois at Urbana-Champaign.

Chart IV: Bureau of Economic and Business Research, University of Illinois at Urbana-Champaign.

Senator DIXON. Professor Resek and Mr. Eckert, I appreciate very much the testimony of both of you. I would appreciate if you could send to me at your earliest convenience those other matters that I have asked about.

Thank you very much, gentlemen.

At this time we welcome to the witness table Mr. Robert G. Gibson, the president of the Illinois State AFL–CIO.

Good morning, Bob.

STATEMENT OF ROBERT G. GIBSON, PRESIDENT, ILLINOIS STATE AFL–CIO

Mr. GIBSON. On behalf of the AFL–CIO, I am grateful to this committee and its chairman for providing the proper forum in which to discuss some of the implications of the proposal to tax employee benefits.

While the idea has been raised ostensibly as a tax and budget issue, it is primarily an issue of basic national social policy. Beginning a century ago in imperial Germany and universally since World War II, the industrial nations of the world have looked upon health care, education, retirement security, and life, disability, and unemployment insurance as fundamental necessities of a stable, progressive society.

Tacitly or explicitly, these countries have perceived that the national interest requires constantly rising minimum standards in each of these areas, and most have dealt with them through the Government programs financed through general revenues. In all of the countries that have chosen this path, such programs have been endorsed, maintained, and expanded by successive governments, both liberal and conservative alike.

The United States, though, chose a different path. Instead of adopting a direct and universal life support system, the Congress chose to try to meet these needs primarily through the Tax Code, by encouraging the untaxed diversion of a part of each worker's wage or salary earnings and other programs specified by Congress from time to time to meet perceived social needs, such as child care and prepaid group legal services.

The success of this social policy is testified to by the fact that 140 million people now have job-related health care protection in the United States. Thus, it is not a tax incentive that has benefited only a small, powerful minority or a narrow, special-interest lobby.

This network of protection was created under the leadership of the American trade union movement, through the institution of collective bargaining, but it has long since become deeply embedded in the Nation's whole employment structure, not the least in the nonunion and antiunion companies that hope, by offering generous benefit programs, to dissuade their employees from organizing.

It would be hard to overstate the role of this life support network in developing the Nation's economy. Until the late 1940's, working people and their families lived with the constant fear that illness or disability would mean dispossession and impoverishment as well. Such is still often the case if the job-related life support system is disrupted by unemployment, as we saw in the recent re-

cession. To many families whose breadwinner was laid off or fired, the loss of health care insurance coverage proved a greater blow than the loss of the job itself.

Some found that even a short hospital stay wiped out all of their savings. Others, without insurance or cash in hand, were stopped at the hospital door and sent to public health facilities, putting a heavy strain on public resources.

With the experience of the recent recession freshly in mind, Congress ought to be considering ways to strengthen the private life support system rather than devising new taxes to undermine it.

The attack on employee benefit programs is taking place at a time of huge and deepening Federal deficits. But the tax treatment of benefits is not the source of this crisis. The attempt to raise revenues by taxing workers' benefits and reducing their standard of living is patently unfair. Even after accounting for the tax increases enacted later, three-fourths of the deficit is directly attributed to the 1981 tax laws, which lavished huge and uncalled for depreciation writeoffs on the Nation's businesses, while giving vastly disproportionate personal tax cuts to the upper income brackets. The revenue shortfall should not be met by levying additional burdens on working people and adding to the unfairness that has characterized economic policies of the past several years.

The employee benefit programs under attack are not frivolous perks or gimmicks to shelter income. They don't generate phony losses or otherwise reduce the taxes of the privileged, but are widely distributed in the national interest.

To qualify for tax exclusions now, benefit plans must comply with stringent rules that prohibit discrimination in favor of owners, officers, shareholders, and highly compensated employees, and generally contain limitations and constraints to assure that the intended beneficiaries and the purposes are served. That test clearly distinguishes these provisions from so many other so-called tax preferences which primarily benefit a privileged few and provide no assurance that any national purpose will be served.

A recent Library of Congress study of employee benefits discusses the many reasons for their growth and underscores their social purpose. Among other things, the study points out that as living standards rise, workers rightly become more concerned about the economic consequences of death, illness, or unemployment and give up wages and other improvements to gain security through essential protections.

The analysis also points out that even with the dramatic increase of benefits on the post-World War II era, the relative level of U.S. fringe benefits still remains a smaller part of total compensation than it is in most other industrialized nations.

In exempting health insurance contributions from taxation, the Congress has promoted private health coverage and lessened the need for a comprehensive public health program. Suggesting such health contributions to taxations would inevitably undermine the private coverage and require a greater direct public role and increased expenditures for the provision of health care.

In advocating the employee health tax, the administration would have citizens believe that health care is a costless fringe to workers. In fact, tough economic decisions are made and other benefits,

including wages, are sacrificed to preserve and enhance the health care benefit package.

All of us are extremely sensitive to the rising cost of health care services, and in collective bargaining increasingly have made the difficult decision in the absence of comprehensive cost-containment legislation to reduce the rate of growth in total health care costs.

This administration also claimed that health insurance benefits are unnecessary subsidies for higher-wage workers. The AFL–CIO strongly rejects this position. Employers contribute the same amount for health coverage per employee regardless of income. As a result, health benefits as a percent of income are more valuable to families at lower wage levels, and limiting tax-free contributions would, therefore, place a disproportionate burden on middle- and lower-income workers who would find it much more difficult to maintain their level of benefits.

The next step is obvious. The young, the single, and the poor, if given the opportunity, would be inclined to opt out of their plans. Those left would be those who can afford the higher costs and those who are older and more in need of frequent health care services. This, in turn, would cause the premiums of the plan to go up, raising taxes further.

Without question, the most mean spirited aspect of the administration's proposal to tax the life support system involves the heaping of further burden on those suffering the loss of employment and the pain of work-related injury, disease, and even death.

Taxing the meager benefits provided under unemployment insurance or workers' compensation adds to the injustice for those workers who have experienced the indignity of job loss or the tragedy of injury or disability stemming from the workplace. Unemployment benefits which would average only $119 per week across the Nation are already subject to taxation if income exceeds $18,000 for married taxpayers and $12,000 for singles.

In 1980 the National Commission on Unemployment Compensation, comprising representatives of employers, workers, and the public, recommended then the repeal of current provisions under which a portion of unemployment insurance income is taxed.

In its report to the President and the Congress, the Commission said: "UI is the first line of defense against extreme hardship caused by unemployment. When a person is unemployed, the family's income stream is already reduced, even if UI is being received. To subject this family's reduced income stream to income taxation adds to the unemployed person's sense of injury already caused by the loss of the job."

Just as devastating is the suggestion by the administration to tax all workers' compensation benefits. At most, workers' compensation replaces two-thirds of lost wages. With caps and ceilings in many cases, it means even less protection.

The 1972 National Commission on Workers' Compensation Laws concluded that in general inadequate benefit levels and inequitable treatment existed in all States. A 1979 report of the Interdepartmental Workers' Compensation Tax Force found that, by the most conservative standards, workers' compensation cash benefits to impaired workers were seriously inadequate.

In the face of these authoritative studies, the administration now wants to make a bad situation immeasurably worse by taxing these benefits and further widening the gap between net income levels and what is necessary to maintain a decent standard of living.

In conclusion, I would again like to commend this committee for holding these hearings on employee benefits. These life support systems are an important part of the Nation's social policy and must not be relegated to the narrow confines of the Tax Code. Therefore, it is particularly gratifying that this committee is conducting this investigation.

Four decades ago few of America's working people enjoyed these benefits. Today, because of such factors as the decisions of the Congress, court decisions, collective bargaining, and the higher wages that have allowed workers to devote more of their income to health and welfare, a large portion of both union and nonunion workers receive a variety of life support benefits. The intent of Congress was clearly to promote the spread of these programs.

Largely because of the revenue shortfall created by the unfair and revenue-eroding Tax Act passed in 1981, these programs are now being eyed as a source of new tax receipts. Nearly three-fourths of the deficit is directly attributable to the unfair give-aways in 1981. The Nation can best resolve the deficit by reversing some of the real inequities in the Tax Code, not by levying additional burdens on working people.

The AFL–CIO strongly urges the members of this committee to resist the proposals to penalize workers and retard privately-financed programs that promote social improvement and the well-being of the American people.

Senator DIXON. Thank you very much for that testimony, Bob.

I wonder whether your organization has given any thought to your attitude about tax simplification in the event that the final bill does contain this kind of provision. In other words, as an alternative to that, do you feel that tax simplification is not beneficial to working people generally, if this kind of a provision remains in the law?

Mr. GIBSON. If you are referring to the recent report, the 400-page report that I have seen that cost $18, as a tax simplification program, I am not sure that is tax simplification at all. A cursory look by our research analysis indicates that that is a Sun Belt proposal. It is not intended as tax simplification. There are some measures in that proposal that do affect workers directly, and in some areas do benefit, especially the poor, in raising the minimum deductions. Those kinds of things are complementary.

However, those that affect the workers' compensation benefits, those that tax unemployment insurance, we obviously would oppose vigorously.

Senator DIXON. Gene Moats suggested earlier—and I don't know whether you were here when he testified to that effect—that he felt that Treasury I with caps was fairer for the average working person, at least in his union, than Treasury II, which simply imposes a minimum tax on all workers. Is that generally the view of organized labor, would you say?

Mr. GIBSON. Yes. Yes, I would——

Senator DIXON. But you would rather see some kind of a cap that excluded lower income people generally than this kind of a minimum tax?

Mr. GIBSON. Right.

Senator DIXON. I thank you very much for your testimony. Your entire statement will be placed in the record. If you have anything further you would like to send us, we would be delighted to have it for the record.

Mr. GIBSON. All right. Thank you.

[The prepared statement of Mr. Gibson follows:]

PRESENTATION TO CONGRESS BY
MR. ROBERT G. GIBSON, PRES.
ILLINOIS STATE AFL-CIO
JUNE 10, 1985

ON BEHALF OF THE AFL-CIO, I AM GRATEFUL TO THIS COMMITTEE FOR PROVIDING THE PROPER FORUM IN WHICH TO DISCUSS SOME OF THE IMPLICATIONS OF THE PROPOSAL TO TAX EMPLOYEE BENEFITS. WHILE THE IDEA HAS BEEN RAISED OSTENSIBLY AS A TAX AND BUDGET ISSUE, IT IS PRIMARILY AN ISSUE OF BASIC NATIONAL SOCIAL POLICY.

BEGINNING A CENTURY AGO IN IMPERIAL GERMANY, AND UNIVERSALLY SINCE WORLD WAR II, THE INDUSTRIAL NATIONS OF THE WORLD HAVE LOOKED UPON HEALTH CARE, EDUCATION, RETIREMENT SECURITY AND LIFE, DISABILITY AND UNEMPLOYMENT INSURANCE AS FUNDAMENTAL NECESSITIES OF A STABLE, PROGRESSIVE SOCIETY.

TACITLY OR EXPLICITLY, THESE COUNTRIES HAVE PERCEIVED THAT THE NATIONAL INTEREST REQUIRES CONSTANTLY RISING MINIMUM STANDARDS IN EACH OF THESE AREAS, AND MOST HAVE DEALTH WITH THEM THROUGH GOVERNMENT PROGRAMS FINANCED THROUGH GENERAL REVENUES. IN ALL OF THE COUNTRIES THAT HAVE CHOSEN THIS PATH, SUCH PROGRAMS HAVE BEEN ENDORSED, MAINTAINED AND EXPANDED BY SUCCESSIVE GOVERNMENTS, LIBERAL AND CONSERVATIVE ALIKE.

THE UNITED STATES HAS CHOSEN A DIFFERENT PATH. INSTEAD OF ADOPTING A DIRECT AND UNIVERSAL LIFE SUPPORT SYSTEM, THE CONGRESS CHOSE TO TRY TO MEET THESE NEEDS PRIMARILY THROUGH THE TAX CODE, BY ENCOURAGING THE UNTAXED DIVERSION OF A PART OF EACH WORKER'S WAGE OR SALARY EARNINGS PROGRAMS AND OTHER PROGRAMS SPECIFIED BY CONGRESS FROM TIME TO TIME TO MEET PERCEIVED SOCIAL NEEDS, SUCH AS CHILD CARE AND PREPAID GROUP LEGAL SERVICES.

THE SUCCESS OF THIS SOCIAL POLICY IS TESTIFIED TO BY THE FACT THAT 140 MILLION PEOPLE NOW HAVE JOB-RELATED HEALTH-CARE PROTECTION IN THE U.S. THUS, THIS IS NOT A TAX INCENTIVE THAT HAS BENEFITED ONLY A SMALL, POWERFUL MINORITY OR A NARROW, SPECIAL-INTEREST LOBBY.

THIS NETWORK OF PROTECTION WAS CREATED UNDER THE LEADERSHIP OF THE AMERICAN TRADE UNION MOVEMENT, THROUGH THE INSTITUTION OF COLLECTIVE BARGAINING, BUT IT HAS LONG SINCE BECOME DEEPLY EMBEDDED IN THE NATION'S WHOLE EMPLOYMENT STRUCTURE, NOT THE LEAST IN THE NON-UNION AND ANTI-UNION COMPANIES THAT HOPE, BY OFFERING GENEROUS BENEFIT PROGRAMS, TO DISSUADE THEIR EMPLOYEES FROM ORGANIZING.

IT WOULD BE HARD TO OVERSTATE THE ROLE OF THIS LIFE-SUPPORT NETWORK IN DEVELOPING THE NATION'S ECONOMY. UNTIL THE LATE 1940'S, WORKING PEOPLE AND THEIR FAMILIES LIVED WITH THE CONSTANT FEAR THAT ILLNESS OR DISABILITY WOULD MEAN DISPOSSESSION AND IMPOVERISHMENT AS WELL. SUCH IS STILL OFTEN THE CASE IF THE JOB-RELATED LIFE-SUPPORT SYSTEM IS DISRUPTED BY UNEMPLOYMENT, AS WE SAW IN THE RECENT RECESSION. TOO MANY FAMILIES WHOSE BREADWINNER WAS LAID OFF OR FIRED, THE LOSS OF HEALTH-CARE INSURANCE COVERAGE PROVED A GREATER BLOW THAN THE LOSS OF THE JOB ITSELF.

SOME FOUND THAT EVEN A SHORT HOSPITAL STAY WIPED OUT ALL THEIR SAVINGS. OTHERS, WITHOUT INSURANCE OR CASH IN HAND, WERE STOPPED AT THE HOSPITAL DOOR AND SENT TO PUBLIC HEALTH FACILITIES, PUTTING A HEAVY STRAIN ON PUBLIC RESOURCES.

WITH THE EXPERIENCE OF THE RECENT RECESSION FRESHLY IN MIND, CONGRESS OUGHT TO BE CONSIDERING WAYS TO STRENGTHEN THE PRIVATE LIFE-SUPPORT SYSTEM RATHER THAN DEVISING NEW TAXES TO UNDERMINE IT.

THE ATTACK ON EMPLOYEE BENEFIT PROGRAMS IS TAKING PLACE AT A TIME OF HUGE AND DEEPENING FEDERAL DEFICITS. BUT THE TAX TREATMENT OF BENEFITS IS NOT THE SOURCE OF THIS CRISIS. THE ATTEMPT TO RAISE REVENUES BY TAXING WORKERS' BENEFITS AND REDUCING THEIR STANDARD OF LIVING IS PATENTLY UNFAIR. EVEN AFTER ACCOUNTING FOR TAX INCREASES ENACTED LATER, THREE-FOURTHS OF THE DEFICIT IS DIRECTLY ATTRIBUTED TO THE 1981 TAX LAWS, WHICH LAVISHED HUGE AND UNCALLED FOR DEPRECIATION WRITE-OFFS ON THE NATION'S BUSINESSES, WHILE GIVING VASTLY DISPROPORTIONATE PERSONAL TAX CUTS TO UPPER INCOME CLASSES. THE REVENUE SHORTFALL SHOULD NOT BE MET BY LEVYING ADDITIONAL BURDENS ON WORKING PEOPLE AND ADDING TO THE UNFAIRNESS THAT HAS CHARACTERIZED ECONOMIC POLICIES OF THE PAST SEVERAL YEARS.

THE EMPLOYEE BENEFIT PROGRAMS UNDER ATTACK ARE NOT FRIVOLOUS PERKS OR GIMMICKS TO SHELTER INCOME. THEY DON'T GENERATE PHONY LOSSES OR OTHERWISE REDUCE THE TAXES OF THE PRIVILEGED, BUT ARE WIDELY DISTRIBUTED IN THE NATIONAL INTEREST.

TO QUALIFY FOR TAX EXCLUSIONS NOW, BENEFIT PLANS MUST COMPLY WITH STRINGENT RULES THAT PROHIBIT DISCRIMINATION IN FAVOR OF OWNERS, OFFICERS, SHAREHOLDERS AND HIGHLY COMPENSATED EMPLOYEES AND GENERALLY CONTAIN LIMITATIONS AND CONSTRAINTS TO ASSURE THAT

THE INTENDED BENEFICIARIES AND PURPOSES ARE SERVED. THAT TEST CLEARLY DISTINGUISHES THESE PROVISIONS FROM SO MANY OTHER SO-CALLED TAX PREFERENCES WHICH PRIMARILY BENEFIT A PRIVILEGED FEW AND PROVIDE NO ASSURANCE THAT ANY NATIONAL PURPOSE WILL BE SERVED.

A RECENT LIBRARY OF CONGRESS STUDY OF EMPLOYEE BENEFITS DISCUSSES THE MANY REASONS FOR THEIR GROWTH AND UNDERSCORES THEIR SOCIAL PURPOSE. AMONG OTHER THINGS THE STUDY POINTS OUT THAT AS LIVING STANDARDS RISE, WORKERS RIGHTLY BECOME MORE CONCERNED ABOUT THE ECONOMIC CONSEQUENCES OF DEATH, ILLNESS OR UNEMPLOYMENT AND GIVE UP WAGES AND OTHER IMPROVEMENTS TO GAIN SECURITY THROUGH ESSENTIAL PROTECTIONS.

THE ANALYSIS ALSO POINTS OUT THAT EVEN WITH THE DRAMATIC INCREASES OF BENEFITS IN THE POST-WORLD WAR II ERA "...THE RELATIVE LEVEL OF U.S. FRINGE BENEFITS STILL REMAINS A SMALLER PART OF TOTAL COMPENSATION THAN IT IS IN MOST OTHER INDUSTRIALIZED NATIONS."

IN EXEMPTING HEALTH INSURANCE CONTRIBUTIONS FROM TAXATION, THE CONGRESS HAS PROMOTED PRIVATE HEALTH COVERAGE AND LESSENED THE NEED FOR A COMPREHENSIVE PUBLIC HEALTH PROGRAM. SUBJECTING SUCH HEALTH CONTRIBUTIONS TO TAXATION WOULD INEVITABLY UNDERMINE PRIVATE COVERAGE AND REQUIRE A GREATER DIRECT PUBLIC ROLE AND INCREASED EXPENDITURES FOR THE PROVISION OF HEALTH CARE.

EMPLOYEE HEALTH TAX

IN ADVOCATING THE EMPLOYEE HEALTH TAX, THE ADMINISTRATION

WOULD HAVE CITIZENS BELIEVE THAT HEALTH CARE IS A COSTLESS "FRINGE" TO WORKERS. IN FACT, TOUGH ECONOMIC DECISIONS ARE MADE AND OTHER BENEFITS, INCLUDING WAGES, ARE SACRIFICED TO PRESERVE AND ENHANCE THE HEALTH CARE BENEFIT PACKAGE. ALL OF US ARE EXTREMELY SENSITIVE TO THE RISING COSTS OF HEALTH CARE SERVICES AND, IN COLLECTIVE BARGAINING, INCREASINGLY HAVE HAD TO MAKE DIFFICULT DECISIONS IN THE ABSENCE OF COMPREHENSIVE COST-CONTAINMENT LEGISLATION TO REDUCE THE RATE OF GROWTH IN TOTAL HEALTH CARE COSTS.

THE ADMINISTRATION ALSO HAS CLAIMED THAT HEALTH INSURANCE BENEFITS ARE UNNECESSARY SUBSIDIES FOR HIGHER WAGE WORKERS. THE AFL-CIO STRONGLY REJECTS THIS POSITION.

EMPLOYERS CONTRIBUTE THE SAME AMOUNT FOR HEALTH COVERAGE PER EMPLOYEE, REGARDLESS OF INCOME. AS A RESULT, HEALTH BENEFITS AS A PERCENT OF INCOME ARE MORE VALUABLE TO FAMILIES AT LOWER WAGE LEVELS. LIMITING TAX FREE CONTRIBUTIONS WOULD, THEREFORE, PLACE A DISPROPORTIONATE BURDEN ON MIDDLE- AND LOWER-INCOME WORKERS WHO WOULD FIND IT MUCH MORE DIFFICULT TO MAINTAIN THEIR LEVEL OF BENEFITS.

THE NEXT STEP IS OBVIOUS: THE YOUNG, THE SINGLE AND THE POOR, IF GIVEN THE OPPORTUNITY, WOULD BE INCLINED TO OPT OUT OF THEIR PLANS. THOSE LEFT WOULD BE THOSE WHO CAN AFFORD THE HIGHER COSTS AND THOSE WHO ARE OLDER AND MORE IN NEED OF FREQUENT HEALTH CARE SERVICES. THIS IN TURN WILL CAUSE THE PREMIUMS OF THE PLAN TO GO UP, RAISING TAXES FURTHER.

WITHOUT QUESTION, THE MOST MEAN-SPIRITED ASPECT OF THE ADMINISTRATION'S PROPOSALS TO TAX LIFE SUPPORT BENEFITS INVOLVES THE HEAPING OF FURTHER BURDENS ON THOSE SUFFERING THE LOSS OF EMPLOYMENT AND THE PAIN OF WORK-RELATED INJURY, DISEASE AND EVEN DEATH. TAXING THE MEAGER BENEFITS PROVIDED UNDER UNEMPLOYMENT INSURANCE OR WORKERS' COMPENSATION ADDS TO THE INJUSTICE FOR THOSE WORKERS WHO HAVE EXPERIENCED THE INDIGNITY OF JOB LOSS OR THE TRAGEDY OF INJURY OR DISABILITY STEMMING FROM THE WORKPLACE.

UNEMPLOYMENT INSURANCE BENEFITS, WHICH AVERAGE ONLY $119 PER WEEK ACROSS THE NATION, ARE ALREADY SUBJECT TO TAXATION IF INCOME EXCEEDS $18,000 FOR MARRIED TAXPAYERS AND $12,000 FOR SINGLES. IN 1980, THE NATIONAL COMMISSION ON UNEMPLOYMENT COMPENSATION, COMPRISING OF REPRESENTATIVES OF EMPLOYERS, WORKERS AND THE PUBLIC, RECOMMENDED THE "REPEAL OF CURRENT PROVISIONS UNDER WHICH A PORTION OF UI INCOME IS TAXED." IN ITS REPORT TO THE PRESIDENT AND THE CONGRESS, THE COMMISSION SAID, "UI IS THE FIRST LINE OF DEFENSE AGAINST EXTREME HARDSHIP CAUSED BY UNEMPLOYMENT. WHEN A PERSON IS UNEMPLOYED, THE FAMILY'S INCOME STREAM IS ALREADY REDUCED EVEN IF UI IS BEING RECEIVED. TO SUBJECT THIS FAMILY'S REDUCED INCOME STREAM TO INCOME TAXATION ADDS TO THE UNEMPLOYED PERSON'S SENSE OF INJURY ALREADY CAUSED BY THE LOSS OF A JOB."

JUST AS DEVASTATING IS THE SUGGESTION BY THE ADMINISTRATION TO TAX ALL WORKERS' COMPENSATION BENEFITS. AT MOST, WORKERS' COMPENSATION REPLACES TWO-THIRDS OF LOST WAGES. CAPS AND CEILINGS

IN MANY CASES MEAN EVEN LESS PROTECTION. THE 1972 NATIONAL COMMISSION ON WORKMEN'S COMPENSATION LAWS CONCLUDED THAT, IN GENERAL, INADEQUATE BENEFIT LEVELS AND INEQUITABLE TREATMENT EXISTED IN ALL STATES. THE 1979 REPORT OF THE INTERDEPARTMENTAL WORKERS' COMPENSATION TASK FORCE FOUND THAT BY THE MOST CONSERVATIVE STANDARDS, WORKERS' COMPENSATION CASH BENEFITS TO IMPAIRED WORKERS WERE SERIOUSLY INADEQUATE. IN THE FACE OF THESE AUTHORITATIVE STUDIES, THE ADMINISTRATION NOW WANTS TO MAKE A BAD SITUATION IMMEASURABLY WORSE BY TAXING THESE BENEFITS AND FURTHER WIDENING THE GAP BETWEEN NET INCOME LEVELS AND WHAT IS NECESSARY TO MAINTAIN DECENT LIVING STANDARDS.

IN CONCLUSION, I WOULD AGAIN LIKE TO COMMEND THIS COMMITTEE FOR HOLDING THESE HEARINGS ON EMPLOYEE BENEFITS. THESE LIFE SUPPORT BENEFITS ARE AN IMPORTANT PART OF OUR NATION'S SOCIAL POLICY AND MUST NOT BE RELEGATED TO THE NARROW CONFINES OF THE TAX CODE. THEREFORE, IT IS PARTICULARLY GRATIFYING THAT THIS COMMITTEE IS CONDUCTING THIS INVESTIGATION.

FOUR DECADES AGO, FEW OF AMERICA'S WORKING PEOPLE ENJOYED THESE BENEFITS. TODAY, BECAUSE OF SUCH FACTORS AS THE DECISIONS OF THE CONGRESS, COURT DECISIONS, COLLECTIVE BARGAINING, AND THE HIGHER WAGES THAT HAVE ALLOWED WORKERS TO DEVOTE MORE OF THEIR INCOME TO HEALTH AND WELFARE, A LARGE PORTION OF BOTH UNION AND NONUNION WORKERS RECEIVE A VARIETY OF LIFE SUPPORT BENEFITS. THE INTENT OF CONGRESS WAS CLEARLY TO PROMOTE THE SPREAD OF THESE PROGRAMS.

LARGELY BECAUSE OF THE REVENUE SHORTFALL CREATED BY THE UNFAIR AND REVENUE-ERODING TAX ACT PASSED IN 1981, THESE PROGRAMS ARE BEING EYED AS A SOURCE OF NEW TAX RECEIPTS. NEARLY THREE-FOURTHS OF THE DEFICIT IS DIRECTLY ATTRIBUTABLE TO THE UNFAIR REVENUE GIVEAWAYS ENACTED IN 1981. THE NATION CAN BEST RESOLVE THE DEFICIT BY REVERSING SOME OF THE REAL INEQUITIES IN THE TAX CODE, NOT BY LEVYING ADDITIONAL BURDENS ON WORKING PEOPLE.

THE AFL-CIO STRONGLY URGES THE MEMBERS OF THIS COMMITTEE TO RESIST THE PROPOSALS TO PENALIZE WORKERS AND RETARD PRIVATELY FINANCED PROGRAMS THAT PROMOTE SOCIAL IMPROVEMENT AND THE WELL BEING OF THE AMERICAN PEOPLE.

Senator DIXON. At this time we would like to welcome Mr. Joseph Ambrose, the president of Financial Insurance Services. Inc., of Oak Brook, IL, and Mr. Robert Bowden, director of agency operations for Independent Insurance Agents of Illinois here in Chicago.

STATEMENT OF JOSEPH T. AMBROSE, PRESIDENT, FINANCIAL INSURANCE SERVICE CONSULTANTS, INC., OAK BROOK, IL

Mr. AMBROSE. I would like to thank you, Senator Dixon, for this opportunity to appear before you.

As a small business person myself, and having 90 percent of my customers fall into that same category, I would like to express my serious reservation about the various proposals to tax employee benefits such as health insurance, life insurance, and pension, and retirement savings programs.

Taxation of these and other employee benefits could have grave consequences for the great majority of American workers who depend on such benefits for their financial security. My firm administers benefit programs, primarily health and life insurance plans, for almost 600 small businesses in the States of Illinois, Michigan, and Tennessee. The number of people covered by these plans approaches 30,000.

Employee benefits are deeply rooted in the fabric of our society and are a prime example of how the Government, through its tax policies over the past 50 years, has encouraged employers and employees to work toward their own financial security. It is because these programs are supported in principle by national policy that they are available to the overwhelming majority of American workers.

The entire impetus of these various proposals has been to raise taxes and to reduce an ever-increasing Federal deficit. While I would agree that the deficit must be reduced, I submit that taxing employee benefits will not accomplish that goal.

It has been estimated that the Government foregoes about $30 billion in revenue per year because employee benefits are not taxed, but it would cost the Government about $80 billion per year to compensate for care now provided under private insurance plans.

To tax these benefits would hurt workers at all income levels, not just higher paid workers, as some have suggested. It would impose a new tax on millions and would be particularly harmful to low- and middle-income workers.

According to the U.S. Census Bureau, 75 percent of workers covered by employee benefit programs earned less than $25,000 in 1982. The following paragraph will serve to highlight certain employee benefits and how they would be affected by the Treasury proposals:

Health insurance is probably the most common employee benefit provided to workers in the United States. The Treasury report does not deal with the problems identified by many analysts when people choose not to buy health insurance or with the Government programs that might eventually be needed if large numbers of low-income taxpayers chose to use limited dollars for food and clothing instead of purchasing health insurance in a tax-neutral world.

The Treasury report focuses primarily on the tax issues while only touching lightly on the social objectives. The Treasury presentation states conclusions without analytic backup in the area of health insurance and its pricing. It states: "Health care is made much more expensive for all because it is effectively subsidized through the tax system for some."

Research conducted for the Senate Aging Committee and the Employee Benefit Research Institute indicates that the tax system subsidy might well make it cheaper for those buying health insurance with after-tax dollars. This is because the nontaxability or the tax subsidy allows health insurance to be priced as a flat, per-employee contribution or cost. It is a convenience to price policies on a flat, per-covered-unit basis. That is to offer, for example, a Blue Cross-Blue Shield to every employee for $90.06 each and then to make the same plan generally available if someone becomes unemployed and wishes to continue coverage or cannot get it from the employer and wants to purchase coverage.

Compare this to the actual cost if each individual had to pay the true economic value of health insurance for his age group. On an age-related basis, coverage virtually identical to the Blue Cross-Blue Shield plan noted above would cost $49.30 for the person under age 30, $122.80 for the person aged 55 through 59, and $180.90 for the person 65 through 69 years old. Would older workers still purchase protection if the true economic value of the employer-provided health insurance were taxed? If they didn't, how long would the Government let them suffer major medical expenses without instituting protection as they have with Medicare and Medicaid?

Were Government policy, as suggested by the Treasury explanation, to attribute equal taxable value to workers of all ages for the same protection, would younger workers stand for it or would adverse selection—younger workers all opting for the cheapest plan—

simply serve to drive up the average cost for the older worker who needs a more comprehensive policy?

Whatever the change, it would have consequences not contemplated in the Treasury Department's justifications.

Senator DIXON. Could I interrupt at that point?

Mr. AMBROSE. Yes, sir.

Senator DIXON. That was very interesting. I thank you for that. It is part of the record.

Can you let me know by letter what that type of plan contemplates that you are referring to here?

Mr. AMBROSE. Certainly.

Senator DIXON. I would appreciate having that.

[Subsequent information was received and follows:]

FINANCIAL INSURANCE SERVICE, INC.

Protecting America's Financial Institutions with Integrity

June 20, 1985

The Honorable Alan J. Dixon
U. S. Senate
Senate Office Building
Washington, D. C. 20540

Dear Senator Dixon:

I very much appreciated the opportunity to testify before the Senate Small Business Committee's June 10, 1985 hearing.

You had asked that I provide you with greater detail with respect to that portion of my testimony that related to the Blue Cross-Blue Shield plan that currently costs $90.06 per employee per month.

I discussed this with Mr. Frank McArdle of the Employee Benefit Research Institute and found that the plan referred to is a major-medical type plan currently in effect for the employees of the Employee Benefit Research Institute i.e. a small, non-profit organization.

The import of the inclusion of the reference was to relate the negative result of taxing an individual on the true economic value of his health benefits. Those least able to afford to pay would be taxed the most, since older people represent greater potential risks and therefore would be charged proportionately higher premiums.

Should you need anything else, please let me know.

Sincerely,

Joseph T. Ambrose
President

JTA/bmm

cc: Mr. Robert J. Peele
Executive Vice President

Mr. R. Dean Conlin
Legal Counsel
Lord, Bissell & Brook
115 South LaSalle Street
Chicago, Illinois 60603

2603 W. 22nd Street, Suite 22 Oak Brook, Illinois 60521 312/850-9500

Mr. AMBROSE. Under life insurance, currently 96 percent of employees in medium and large firms receive employer-provided life insurance. Life insurance provides backup protection for the families of workers who are not covered by pension plans or who are covered but may not yet be fully vested.

The Treasury proposal would include all employer-paid life insurance premiums in the employee's taxable income. Currently only those premiums financing insurance in excess of $50,000 are taxable income to the employee. While employer-paid life insurance premiums make up a small share of total compensation, this extra tax burden could encourage younger employees, low earners, single employees, and second earners to opt out of employer-provided plans rather than pay the added taxes. Employer-provided insurance could deteriorate.

Since these employees opting out would be those not foreseeing the need for the protection, this would seem to be in conflict with the provisions of the Retirement Equity Act of 1984, which sought to increase the economic resources available to surviving spouses, particularly those in older age groups. Such issues need to be reconciled with the tax effects before further action is taken.

If some employees opted out of employer-sponsored plans, the cost for insuring the remaining employees would increase. More importantly, however, the value of life insruance protection as a source of income security could be weakened.

Cafeteria plans—no one else really touched on this, Senator Dixon, but we are certainly finding more, even small, employers referring to flexible-type benefit programs where people, dependent upon their age and family status, are free to choose within certain limited and currently tax-effective choices of benefits. That is, if you don't need as much life insurance protection, you may opt out of that and go in, say if you have a large family, to greater health insurance protection, et cetera.

The Treasury proposal would repeal section 125 of the Internal Revenue Code which authorizes flexible benefits or cafeteria plans. As directed by the Tax Reform Act of 1984, the Department of Health and Human Services, in consultation with the Treasury Department, is conducting a study to determine the role of these plans in containing health care costs. Many employers believe that these plans can be used to contain health care costs, but large-scale, statistical evidence on this point is not yet available.

The Treasury proposal would make the Health and Human Services study a moot point. The HHS study should be completed and evaluated before additional changes in this area are legislated. The findings from the study should be considered in conjunction with the health insurance tax cap discussion.

The Treasury report gives no recognition to the aging of the population, increases in female labor force participation, the growth of two-income households, and possible effects of these changes on employees' needs or attitudes. These are factors that flexible benefit plans have been designed to accommodate.

The report states, and this is the Treasury report:

> Presently, the exclusion of fringe benefits from taxable income has gone so far that it has become necessary to offset the distorting effects of some tax provisions by allowing employers to offer a choice of tax-free benefits. On the one hand, cur-

rent law encourages the use of tax-free forms of compensation, but on the other it attempts to counteract these incentives by allowing employers to offer employees the choice that is normally associated with payment of wages in cash.

Under the Treasury Department proposals, it will not be necessary to restrict so-called cafeteria plans, plans that allow employees to choose among tax-exempt fringe benefits. Since premiums for medical insurance below the proposed cap will be the only major statutory fringe benefit that will remain exempt, the provisions authorizing tax-free cafeteria plans will be largely redundant and should be repealed." Again, that is the Treasury's view.

Of course, employers and their employees may find nontax reasons, such as lower insurance rates for groups and the accommodation of different preferences, for allowing employees to select from a menu of taxable fringe benefits. Cafeteria plans might continue for this purpose.

The Employee Benefit Research Institute analysis indicates that, even in the case of health insurance, employers might find it necessary in the presence of partial taxation and the repricing per employee that would likely be required to allow employees the option of no health insurance. The need for extensive communication of why employees should have health insurance might become very necessary in order to convince low-income workers to purchase it.

Also, the per-plan, per-employee pricing proposed by the Treasury might actually make a cafeteria plan recordkeeping system more essential for benefit administration than at present. Why? Because employees might demand alternative levels of coverage, and, therefore, effective pricing by age group due to adverse selection to offset the potential age discrimination effects of the Treasury proposal.

The Treasury notes: "Employees will compare the full market prices of formally subsidized consumption with other uses of their after-tax dollars. As a result, it is expected that employers would provide less life insurance and legal insurance and that employees will purchase more directly. Purchases of insurance for marginal amounts of health coverage will also decline."

The Treasury then gives its opinion of the result from employee benefit-related tax changes: "Employers can continue, in effect, to offer certain goods and services for sale for salary deduction, but in the absence of tax inducements for paying wages as fringe benefits, most compensation will be in cash."

The potential problem is large numbers of workers who need the coverage tomorrow may not purchase any today, and will then find themselves unable to afford quality care.

VEBA's, or Voluntary Employee Benefit Associations—again, for your own edification, Senator, we have found in our own business that many employers, typically small employers who belong to a particular trade association, find these vehicles particularly helpful in terms of allowing them a low-cost alternative to a relatively high-cost plan of benefits, particularly when we are talking about health or disability coverages. Again, the mass purchasing power of all these combined small employers allows them to work quite efficiently in this marketplace.

The Treasury proposal would tax the income of these voluntary employees beneficiary associations, supplemental unemployment benefit trusts, and black lung trusts, but the existing rules governing employer contributions for deductions to these associations and trusts would not be altered.

Treasury Department report, volume 2, gives the following rationale for its proposed change:

> The tax benefit of tax-exempt growth for amounts set aside to fund deferred compensation should generally not be available outside of the qualified retirement plan area. Although the rules adopted in the Tax Reform Act of 1984 will limit the type and levels of benefits for which an employer may prefund on a tax-favored basis, the advantage of tax-exempt growth remains for certain benefits within the specified limits. This exemption of investment income from tax effectively shifts a portion of the cost of employee compensation to the general public.
>
> In addition, continuation of the exemption would be inconsistent with the tax treatment of reserves for welfare benefits under a policy with an insurance company. The Treasury Department proposals include taxation of the income on reserves held by casualty insurance companies. In order not to provide more favorable tax treatment to self-insured benefit arrangements than to insured arrangements, the income earned by VEBA's, supplemental unemployment benefit trusts, and black lung trusts should similarly be subjected to tax.

Again, I would take issue with that from the standpoint that again these voluntary employee benefit association trusts do allow and are controlled by not only Federal legislation that was passed in 1981, but also are increasingly being subject to State regulation as State insurance departments right here in the State of Illinois are becoming increasingly aware of their impact and importance.

Retirement savings—the Treasury Department's proposals in the area of retirement savings would apply to pension plans offered by employers in the public and the private sectors, which together cover approximately 52 million workers.

The Treasury discussion in this area gives immediate recognition to the social and economic objectives of retirement savings programs—which are the provision of retirement income and capital accumulation—and seems to accept them without reservation. Tax neutrality is not raised as an issue; a tax policy justification for the breach of neutrality is not provided. Additionally, the Treasury report includes no analysis of the relative effectiveness or efficiency of the alternative programs for which incentives are provided in terms of either horizontal or vertical equity.

By encouraging taxpayers to save for retirement, the tax-preferred treatment of retirement plans serves two important public purposes. It helps retirees accumulate funds so they can live out their lives in dignity without becoming wards of society, and it produces saving that can be made available for capital formation. In the latter sense, tax-preferred retirement plans have much the same benefits as a consumed income tax, but without its other disadvantages.

The Treasury proposal represents a back-to-basics approach to retirement benefits, however, in that retirement plan distributions made at termination of service before retirement will be penalized if they are not rolled over into a qualified retirement plan or IRA's.

The Treasury report does not provide an analysis or a full rationale for this complement of recommendation. It appears, however, that the combination of retirement proposals would have a number of noticeable effects. First, lump-sum distributions would be very much disadvantaged compared to current law, and payouts as streams or annuities would be encouraged.

Second, the changes place a significantly greater emphasis on retirement income provisions through employer dollars exclusively with the elimination of 401(k) plans.

Third, the changes make defined benefit plans relatively more attractive.

Fourth, they make the distinctions between employer plans and IRA's more pronounced in terms of the ability to reclaim funds prior to retirement.

Under the Treasury proposal, the structure of retirement plans would be changed dramatically. The proposal imposes significant restrictions on the use of distributions from qualified plans to assure that these plans are used to provide retirement income in the form of periodic benefit or annuity payments, rather than one-time lump-sum distributions, either before or at retirement. This could reduce retirement planning flexibility for persons with more than one retirement plan who might want to use benefits from the primary plan for retirement income and benefits from secondary plans for a home purchase or other large expenditure. As the population ages, the numbers of persons retiring with benefits from more than one pension plans—benefits they may want to use differently —would grow.

Our finding ourselves in a business that employs less than 50 people, as our own business does, is that we have— and I am sure that this is something that we are seeing across the country; I have seen some statistics on it, Senator, relative to the number of people that are in more or less a transient state; that is to say, although they may want to stay in a particular geographic area, because of their particular skills and the lack of a need for those skills in a particular area, we are seeing those people move to other geographic locales.

Well, the big issue with those people is the fact that they see, as it relates certainly to retirement plans, some degree of portability. You cannot always treat that person as being a ward of the State or a ward of the Nation in terms of saying, "Well, you're not able to best serve your own needs by having use of those funds."

Again, encouraging these types of savings plans such as the 401(k) plans which, of course, the key feature being that the employee is in a position to take a certain portion, up to a prescribed amount, and shelter that from taxation, allow him to save that— you, undoubtedly, have seen some figures relative to savings rates among the various nations of the world, and it is surprising to see our own United States be probably on the lower end of the totem pole as it relates to individual savings People are just not saving money. This is one vehicle that allows people to accumulate funds for that very necessary purpose of retirement.

Again, it appears quite obvious that the very people who need the protection most acutely could not accept lower take-home pay, would choose less protection, or be forced to withdraw from private protection programs altogether. The inevitable result would be the growing national demand for new Government programs to fill the gap.

Mr. Dixon, very real needs are now being met by the private sector. I believe that reducing the individual's ability to provide for adversity and a secure retirement is an unwise step, and ask that

you and members of the Committee on Small Business look closely at the serious long-term consequences of taxing employee benefits.

Senator DIXON. Thank you very much, Mr. Ambrose.

[The prepared statement of Mr. Ambrose follows:]

FINANCIAL INSURANCE SERVICE CONSULTANTS, INC.

Specialists in the Design and Administration of Employee Benefit Plans

June 7, 1985

The Honorable Alan J. Dixon
U.S. Senate
Senate Office Building
Washington D.C. 20540

Dear Senator Dixon:

As a small business person myself and having 90% of my customers fall into that same category, I would like to express my serious reservations about the various proposals to tax employee benefits, such as health insurance, life insurance, and pension and retirement savings programs. Taxation of these and other employee benefits could have grave consequences for the great majority of American workers, who depend on such benefits for their financial security.

My firm administers benefit programs, primarily health and life insurance plans, for almost six hundred (600) small businesses in the State of Illinois, Michigan, and Tennessee. The number of people covered by those plans approaches thirty thousand (30,000).

Employee benefits are deeply rooted in the fabric of our society, and are a prime example of how the government, through its tax policies over the last fifty years has encouraged employees to work toward their own financial security. It is because these programs are supported in principle by national policy that they are available to the overwhelming majority of American workers.

The entire impetus of these various proposals has been to raise taxes to reduce an ever-increasing federal deficit. While I would agree that the deficit must be reduced, I submit that taxing employee benefits will not accomplish that goal.

It has been estimated that the government foregoes about $30 billion in revenue per year because employee benefits are not taxed, but it would cost the government about $80 billion per year to compensate for care now provided under private insurance plans.

To tax these benefits would hurt workers at all income levels, not just higher paid workers, as some have suggested. It would impose a new tax on millions and would be particularly harmful to low- and middle-income workers. According to the U.S. Census Bureau, 75 percent of workers covered by employee benefit programs earned less than $25,000 in 1982.

The following paragraphs will serve to highlight certain employee benefits and how they would be affected by the Treasury proposal.

2603 W. 22nd Street, Suite 22 Oak Brook, Illinois 60521 312/850-9500

Health Insurance

Health Insurance is probably the most common employee benefit provided to workers in the United States. The Treasury report does not deal with the problems identified by many analysts when people choose not to buy health insurance, or with the government programs that might eventually be needed if large numbers of low income taxpayers choose to use limited dollars for food and clothing instead of purchasing health insurance in the tax neutral world. The treasury report focuses primarily on the "tax issues," while only touching lightly on the social objectives.

The Treasury presentation states conclusions without analytic backup in the area of health insurance and its pricing. It states: "Health care is made much more expensive for all because it is effectively subsidized through the tax system for some." Research conducted for the Senate-Aging Committee and the Employee Benefit Research Institute indicates that the tax system subsidy might well make it cheaper for those buying health insurance with after tax dollars. This is because the nontaxability or the tax subsidy allows health insurance to be priced as a flat, per employee contribution or cost. It is a convenience to price policies on a flat, per covered unit basis - i.e., to offer, for example, a Blue Cross-Blue Shield plan to every employee for $90.06 each - and then to make the same plan generally available if someone becomes an unemployed and wishes to continue coverage, or can't get it from employer and wants to purchase coverage.

Compare this to the actual cost if each individual had to pay the true economic value of health insurance for his age group. On an age-related basis, coverage virtually identical to the Blue Cross-Blue Shield plan noted above would cost $49.30 for the person under age 30, $122.80 for the person ages 55-59 and $180.90 for the 65-69 year old. Would older workers still purchase protection if the true economic value of employer-provided health insurance were taxed? If they didn't, how long would the government let them suffer major medical expenses without instituting protection, as they have with Medicare and Medicaid? Were government policy, as suggested by the Treasury explanation, to attribute equal taxable value to workers of all ages for the "same" protection, would younger workers stand for it? Or, would adverse selection - younger workers all opting for the cheapest plan - simply serve to drive up the average cost for the older worker who needs a more comprehensive policy? Whatever the change, it would have consequences not contemplated in the Treasury Department's justifications.

Life Insurance

Currently, 96% of employees in medium and large firms receive employer-provided life insurance. Life insurance provides backup protection for the families of workers who are not covered by pension plans or who are covered but may not yet be fully vested.

The Treasury proposal would include all employer-paid life insurance premiums in the employee's taxable income. Currently, only those premiums financing insurance in excess of $50,000 are taxable income to the employee. While employer-paid life insurance premiums make up a small share of total compensation, this extra tax burden could encourage younger employees, low earners, single employees and second earners to opt out of employer-provided plans rather than pay the added taxes. Employer-provided insurance could deteriorate, since those employees opting out would be those not foreseeing the need for the protection. This would seem to conflict with the provisions in the Retirement Equity Act of 1984, which sought to increase the economic resources available to surviving spouses, particularly those in older age groups. Such issues need to be reconciled with the tax effects before further action is taken.

If some employees opted out of employer-sponsored plans, the costs for insuring the remaining employees would increase. More importantly, however, the value of life insurance protection as a source of income security could be weakened.

Cafeteria Plans

The Treasury proposal would repeal Section 125 of the Internal Revenue Code, which authorizes flexible benefit or cafeteria plans. As directed by the Tax Reform Act of 1984, the Department of Health and Human Services (HHS), in consultation with the Treasury Department, is conducting a study to determine the role of these plans in containing health care costs. Many employers believe that these plans can be used to contain health care costs, but large scale statistical evidence on this point is not yet available. The Treasury proposal would make the HHS study moot. The HHS study should be completed and evaluated before additional changes in this area are legislated. The findings from this study should be considered in conjunction with the health insurance tax cap discussion.

The Treasury report gives no recognition to the aging of the population, increases in female labor force participation, the growth of two income households and the possible effects of these changes on employees' needs or attitudes. These are factors that flexible benefit plans have been designed to accommodate. The report states:

> Presently the exclusion of fringe benefits from taxable income has gone so far that it has become necessary to offset the distorting effects of some tax provisions by allowing employers to offer a choice of tax free benefits. On the one hand, current law encourages the use of tax free forms of compensation, but on the other it attempts to counteract these incentives by allowing employers to offer employees the choice that is normally associated with payment of wages in cash. Under the Treasury Department proposals, it will not be necessary to restrict so-called cafeteria plans, plans that allow employees to choose among tax exempt fringe benefits. Since premiums for medical insurance below the proposed cap will be only major statutory fringe benefit that will remain exempt, the provisions authorizing tax free cafeteria plans will be largely redundant and should be repealed. Of course, employers - and their employees - may find nontax reasons, such as lower insurance rates for groups and the accommodation of different preferences, for allowing employees to select from a menu of taxable fringe benefits. Cafeteria plans might continue for this purpose.

EBRI analysis indicates that even in the case of health insurance, employers might find it necessary, in the presence of partial taxation and the repricing per employee that would likely be required, to allow employees the option of no health insurance. The need for extensive communication of why employees should have health insurance might become very necessary in order to convince low income workers to purchase it. Also, the per plan per employee pricing proposed by the Treasury might actually make a cafeteria plan and recordkeeping system more essential for benefit administration than at present. Why? Because employees might demand alternative levels of coverage, and, therefore, effective pricing by age group due to "adverse" selection, to offset the potential age discrimination effects of the Treasury proposal.

> The Treasury notes:
> Employees will compare the full market prices of formerly subsidized consumption with other uses of their after tax dollars. As a result, it is expected that employers will provide less life insurance and legal insurance, and that employees will purchase more directly. Purchases of insurance for marginal amounts of health coverage will also decline.

The Treasury then gives its opinion of the result from employee benefit related tax changes:

> Employers can continue, in effect, to offer certain goods and services for sale through salary deductions, but in the absence of tax inducements for paying wages as fringe benefits, most compensation will be in cash.

The potential problem is: Large numbers of workers who need coverage tomorrow may not purchase any today, and will find themselves unable to afford quality care.

VEBAs

The Treasury proposal would tax the income of voluntary employees' beneficiary associations (VEBAs), supplemental unemployment benefit (SUB) trusts and black lung trusts. But the existing rules governing employer contributions for deductions to these associations and trusts would not be altered.

The Treasury Department report (Volume 2) gives the following rationale for its proposed change:

> The tax benefit of tax exempt growth for amounts set aside to fund deferred compensation should generally not be available outside of the qualified retirement plan area. Although the rules adopted in the Tax Reform Act of 1984 will limit the type and levels of benefits for which an employer may prefund on a tax-favored basis, the advantage of tax exempt growth remains for certain benefits within the specified limits. This exemption of investment income from tax effectively shifts a portion of the cost of employee compensation to the general public.
>
> In addition, continuation of the exemption would be inconsistent with the tax treatment of reserves for welfare benefits under a policy with an insurance company. The Treasury Department proposals include taxation of the income on reserves held by casualty insurance companies. In order not to provide more favorable tax treatment to self-insured benefit arrangement than to insured arrangements, the income earned by VEBAs, SUB trusts and black lung trusts should similarly be subjected to tax.

Retirement Savings

The Treasury Department's proposals in the area of retirement savings would apply to pension plans offered by employers in the public and the private sectors, which together cover approximately 52 million workers.

The Treasury discussion in this area gives immediate recognition to the social and economic objectives of retirement savings programs - which are the provision of retirement income and capital accumulation - and seems to accept them without reservation. Tax neutrality is not raised as an issue; a tax policy justification for the breach of neutrality is not provided. Additionally, the Treasury report includes no analysis of the relative effectiveness or efficiency of the alternative programs for which incentives are provided in terms of either horizontal or vertical equity.

By encouraging taxpayers to save for retirement, the tax-preferred treatment of retirement plans serves two important public purposes. It helps retirees accumulate funds so they can live out their lives in dignity without becoming wards of society, and it produces saving that can be made available for capital formation. In the latter sense, tax-preferred retirement plans have much the same benefits as a consumed income tax, but without its other disadvantages.

The Treasury proposal represents a "back-to-basics" approach to retirement benefits, hoever, in that retirement plan distributions made at termination of service before retirement will be penalized if they are not rolled over into a qualified retirement plan or IRA.

The Treasury report does not provide an analysis or a full rationale for this complement of recommendations. It appears, however, that the combination of retirement proposals would have a number of noticeable effects. First, lump sum distributions would be very much disadvantaged compared to current law, and pay-outs as streams or annuities would be encouraged. Second, the changes place a significantly greater emphasis on retirement income provision through employer dollars, exclusively, with the elimination of 401(k) plans. Third, the changes make defined benefit plans relatively more attractive. Fourth, they make the distinctions between employer plans and IRAs more pronounced in terms of the ability to "reclaim" funds prior to retirement.

Under the Treasury proposal, the structure of retirement plans would be changed dramatically. The proposal imposes significant restrictions on the use of distributions from qualified plans to assure that these plans are used to provide retirement income in the form of periodic benefit or annuity payments, rather than in onetime lump sum distributions, either before or at retirement. This could reduce retirement planning flexibility for persons with more than one retirement plan, who might want to use benefits from the primary plan for retirement income and benefits from secondary plans for a home purchase or other large expenditure. As the population ages, the numbers of persons retiring with benefits from more than one pension plan - benefits they may want to use differently - would grow.

It appears quite obvious that the very people who need the protection most acutely could not accept lower take-home pay, and would choose less protection or be forced to withdraw from these private protection programs altogether. The inevitable result would be a growing national demand for new government programs to fill the gap.

Mr. Dixon, very real needs are now being met by the private sector. I believe that reducing the individuals ability to provide for adversity and a secure retirement is an unwise step and ask that you look closely at the serious longer term consequences of taxing employee benefits.

Respectfully submitted,

Joseph T. Ambrose

Joseph T. Ambrose
President

JTA/bmm

Senator DIXON. I am delighted now to recognize Mr. Robert Bowden, director of agency operations, Independent Insurance Agents of Illinois.

STATEMENT OF ROBERT BOWDEN, DIRECTOR OF AGENCY OPERATIONS, INDEPENDENT INSURANCE AGENTS OF ILLINOIS, CHICAGO, IL; ALSO REPRESENTING THE INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.

Mr. BOWDEN. Thank you, Mr. Chairman.

As you have indicated, my name is Robert Bowden, and I am director of agency operations for the Independent Insurance Agents of Illinois, but today I am representing not only the Illinois agents, but the 34,000 independent insurance agents across America that constitute the Independent Insurance Agents of America, Inc. [IIAA].

We commend you for holding these field hearings, because in our view nothing is more important to the life blood of all business, both large and small, than this particular issue.

For almost half a century, Congress has encouraged American business and labor to create and maintain employee benefit programs, all for the security of the Nation's workers and all their dependents. A key element in providing this support for these private sector efforts has been the tax treatment afforded certain benefits under current law.

This tax treatment has produced impressive results at a minimum cost to the Government. According to a 1983 survey conducted by the U.S. Chamber of Commerce, 99 percent of all the firms surveyed offered some form of group health and life insurance protection to their employees; 83 percent offered a pension; and 65 percent offered education assistance programs; 162 million American workers and their families are protected. A sizable portion of that number are the owners and operators of small businesses.

Mr. Chairman, there are a number of issues that are important to small business in the President's tax plan, most importantly the proposal to discount loss reserves for property and casualty insurance companies. The insurance product is the great common denominator of all small business —in truth, the insurance business is everyone's business. Since your hearing today is concerned only with the taxation of employee benefits, I will focus my testimony on the taxation of health insurance benefits, because surveys that we have seen, indicate that health care taxation frightens the American public more than any other tax on any employee benefits.

The demographics of our Nation are such that our "baby boom generation" will soon be our "aging boom generation," so any tax on health benefits instituted now will have a much greater effect on individuals as the years pass.

Taxing health benefits is bad health policy. A health tax would dismantle the economic safety net provided to American workers by private enterprise. Present tax policy has effectively replaced the need for a costly national health insurance program. The development of private employee group health insurance has opened channels of insurance to millions of workers regardless of their

age, sex, physical condition, or character of their employment. In doing so, the contributions of employers and employees have drastically reduced pressure on charities, social and Government services in general, and Medicare and Medicaid in particular.

For any employee group insurance to work, essentially all employees in a group must be covered. If you increase direct cost to the employee, either through taxation or otherwise, young, healthy, and the low-income workers will drop out. As these workers leave the group, costs for the older and less healthy workers go up in the form of higher premiums and out-of-pocket expenses. And, as usual, it is the low-income worker who will be hit the hardest. In summary, take away favorable tax policy, and you move the burden from the private to the public sector.

Senator DIXON. I think that is an important point, Mr. Bowden—that the very end result of what the administration is contemplating here might very well be to ultimately put this in the public sector.

Mr. BOWDEN. I think it would be inevitable.

A health tax penalizes the older workers. Elderly groups tend to use health care more frequently than younger, healthier workers. That is just an obvious fact. Hence, the cost of health insurance for groups including more than the average number of older workers not only will be higher in price, but could discourage many employers from hiring older workers. This same principle may be applied to other risk groups, including women and the disabled.

Taxing health benefits is bad tax policy. A health tax is a regressive tax. Decrease employer-provided health benefits and the resultant increase in out-of-pocket health costs due to a health tax would hit hardest on those least able to afford it. In data presented to Congress in 1983, the Employee Benefit Research Institute, [EBRI,] stated that "as a proportion of income, persons at the lowest level of income—those reporting less than $10,000—would pay more than six times the amount of tax than would persons with income over $50,000."

EBRI concluded that, again quoting, "current tax policy probably raises private coverage rates significantly among lower-income worker households, households with fragmented employment histories, younger households, and both single-person and single-parent households." Taxing employee health plans could seriously undermine all these successes.

A health tax is really a form of double taxation. The Health Insurance Association of America estimates that Medicare and Medicaid payment practices resulted in $8.8 billion being shifted to patients covered by private health insurance in 1984 alone to make up for the Government underpayment to hospitals. For the Government to shift these costs to the private sector and then put a tax on the resulting higher insurance premiums is patently unfair. Further, as pointed out above, it will be the sick and those most dependent on health insurance who will bear the burden of this cost shift.

A health tax would penalize employees of small businesses. Small employers generally pay higher premiums than large employers for comparable plans. Hence, small employers would represent a disproportionate number of the employers affected by a

health tax. Further, many small businesses have indicated that they would be forced to terminate their group health plans due to the increased administrative burden of adjusting payroll and benefit procedures to a health tax.

Much has been made of the fact that the original Treasury proposal used a ceiling approach to health taxation; that is, taxing benefits above a certain amount per month, while the President's tax plan utilized a floor approach; that is, taking all receipts on the value of a certain amount of employer-provided coverage—$10 per month for single employees and $25 per month for families.

This proposal is extremely dangerous because, while it appears more fair at first glance, it has two characteristics that we feel argue against it:

It is the most regressive tax of all, hitting lower-income workers the hardest.

While the relative dollar amount as proposed is small, next year, or the year after, it would be very easy to simply raise the floor and tax a higher amount from the first dollar. In fact, on the June 2d ABC television program, "This Week with David Brinkley," Ways and Means Committee Chairman Rostenkowski stated that a tax increase next year is "inevitable." I think that if the health tax becomes law, it will be a part of that "inevitability" that "Rosty" refers to.

Senator DIXON. I will tell "Rosty" what you said. [Laughter.]

Mr. BOWDEN. In summary, the current tax treatment of employee benefit plans, and the employee health insurance coverage in particular, has a high positive social value and we don't think it should be tinkered with.

Thank you very much.

Senator DIXON. Thank you very much, Mr. Bowden.

[The prepared statement of Mr. Bowden follows:]

STATEMENT OF

THE INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.

ON

THE IMPACT OF TAXING EMPLOYEE BENEFITS ON SMALL BUSINESS

BEFORE

THE

SENATE SMALL BUSINESS COMMITTEE

June 10, 1985

Chicago, Illinois

Presented By:

Robert Bowden
Director of Agency Operations
Independent Insurance Agents of Illinois

Mr. Chairman, my name is Robert Bowden, and I am Director of Agency Operations for the Independent Insurance Agents of Illinois. Today I am representing both the Illinois agents, and the 34,000 independent insurance agencies across America that constitute the Independent Insurance Agents of America, Inc. (IIAA).

You are to be commended for holding this field hearing, because no subject is so important to the lifeblood of American business, both large and small.

For almost a half century, Congress has encouraged American business and labor to create and maintain employee benefit programs for the security of the nation's workers and their dependents. A key element in providing support for these private sector efforts has been the tax treatment afforded certain benefits under current law.

This tax treatment has produced impressive results at a minimum cost to the government. According to a 1983 survey conducted by the U.S. Chamber of Commerce, 99 percent of the firms surveyed offered group health and life insurance protection to employees, 83 percent offered a pension, and 65 percent offered education assistance programs. One hundred and sixty two million American workers and their families are protected. A sizable portion of that number are the owners and employees of small business.

Mr. Chairman, there a number of issues that are important to small business in the President's tax plan, most importantly the proposal to discount loss reserves for property/casualty insurance companies. The insurance product is the great common denominator of all small businesses -- in truth, the insurance business is everyone's business. Because your hearing today is concerned only with the taxation of employee benefits, I will focus my testimony on the taxation of health insurance benefits, because surveys indicate that health taxation scares the American people more than any other tax on employee benefits.

The demographics of our nation are such that our "baby boom" generation will soon be our "aging boom" generation, so any tax on health benefits instituted now will have a much greater effect on individuals as the years pass.

TAXING HEALTH BENEFITS IS BAD HEALTH POLICY

A health tax dismantles the economic safety net provided to American workers by private enterprise -- present tax policy has effectively replaced the need for a costly national health insurance program. The development of private employee group health insurance has opened channels of insurance to millions of workers regardless of age, sex, physical condition, or character of employment. In doing so, the contributions of employers and employees have drastically reduced pressure on charities, social and government services in general, and Medicare and Medicaid in particular.

For employee group insurance to work, essentially all employees in a group must be covered. If you increase direct costs to the employee, through taxes or otherwise, young, healthy and low-income workers will drop out. As these workers leave the group, costs for older and less healthy workers go up in the form of higher premiums and out-of-pocket costs. And, as usual, it is the low-income worker who will be hit the hardest. In summary, take away favorable tax policy, and you move the burden from the private to the public sector.

A health tax penalizes older workers -- Elderly groups tend to use health care more frequently than younger, healthier workers. Hence, the cost of health insurance for groups including more than the average number of older workers not only will be higher in price, but could discourage many employers from hiring older workers. This same principle may be applied to other high "risk" groups, including women and the disabled.

TAXING HEALTH BENEFITS IS BAD TAX POLICY

A health tax is a regressive tax -- Decrease employer provided health benefits and the resultant increase in out-of-pocket health costs due to a health tax would hit hardest on those least able to afford it. In data presented to Congress in 1983, the Employee Benefit Research Institute (EBRI) stated that "as a proportion of income, persons at the lowest level of income (those reporting less than $10,000) would pay more than six times the amount of tax than would persons with income over $50,000."

EBRI concluded that "...current tax policy probably raises private coverage rates significantly among lower-income worker households, households with fragmented employment histories, younger households, and both single-person and single-parent households." Taxing employee health plans could seriously undermine these successes.

A health tax is a form of "double taxation" -- The Health Insurance Association of America estimates that Medicare and Medicaid payment practices resulted in $8.8 billion being shifted to patients covered by private health insurance in 1984 to make up for government underpayment to hospitals. For the government to shift these costs to the private sector and then put a tax on the resulting higher insurance premiums is patently unfair. Further, as pointed out above, it will be the sick and those most dependent on health insurance who will bear the burden of this cost-shift.

A health tax would penalize employees of small businesses -- Small employers generally pay higher premiums than large employers for comparable plans. Hence, small employers would represent a disproportionate number of the employers affected by a health tax. Further, many small businesses have indicated that they would be forced to terminate their group health plans due to the increased administrative burden of adjusting payroll and benefit procedures to a health tax.

Much has been made of the fact that the original Treasury proposal used a ceiling approach to health taxation, i.e., taxing benefits above a certain amount per month, while the President's tax plan utilizes a "floor" approach, i.e., taxing all recipients on the value of a certain amount of employer provided coverage -- $10.00 per month for single employees and $25.00 per month for families.

This proposal is extremely dangerous, because while it appears more fair at first glance, it has two characteristics which argue against it.

1. It is the most regressive tax of all, hitting lower income workers the hardest, and
2. While the relative dollar amount as proposed is small, next year, or the year after, it would be easy to simply "raise the floor" and tax a higher amount from the first dollar. In fact, on the June 2 ABC Television program "This Week with David Brinkley," Ways & Means Committee Chairman Rostenkowski stated that a tax increase next year is "inevitable." I think that if the health tax becomes law, it will be a part of that "inevitability" that "Rosty" refers to.

In summary, the tax treatment of employee benefit plans, and employee health insurance coverage in particular, has a high, positive social value, and should not be tinkered with.

Thank you Mr. Chairman, and I would be happy to answer any questions you may have.

Senator DIXON. I suppose if one clear thing came through on the entire hearing, it is that while there might be some differences of opinion—and the chairman of this hearing notes that—about whether you ought to tax fringe benefits or not, clearly everybody thinks that Treasury II is a worse idea than Treasury I in this area. I wonder what motivated the administration to make that kind of a switch. I suppose that is something that will be revealed in time.

In any event, let me say that this is a hearing of the Small Business Committee, chaired by Lowell Weicker, the distinguished senior Senator from Connecticut, held in the city of Chicago on this date.

We thank you all for the testimony you have given. Any other relevant matters that you would like to include in the record, we would appreciate your sending to us: Senator Alan Dixon, 316 Hart, H-a-r-t, Building, Washington, DC, 20510, I guess. We would be delighted to include it in the record. I would particularly like those who indicated they would send some information to me earlier to remember to do so, particularly in your case, Professor. I thank you.

Thank you all for coming here this morning.

This meeting is adjourned.

[Whereupon, at 11:15 a.m., the committee recessed to reconvene at the call of the Chair.]

APPENDIX

SPBA SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS
2033 M Street, NW • Suite 605 • Washington, D.C. 20036 • (202) 223-6413

Testimony of the Society of Professional Benefit Administrators (SPBA)
by Executive Director Frederick D. Hunt, Jr.

United States Senate Committee on Small Business
June 10, 1985

Taxation of Employee Benefits & the Effects on Small Business by the President's Tax Reform Proposals

Everyone pays lip service to the fact that small business today and in the future is the major source of employment for Americans. However, tax policy affecting the employee benefits offered by small business is downright antagonistic. We commend you for holding these hearings in an effort to gain a more practical policy perspective. Your effort is important and desperately needed.

Mr. Chairman, when it comes to employee benefits, small business is victim of two prejudices: (1) There is a mentality in the Congressional and regulatory tax circles that all small businessmen are greedy entrepreneurs who only offer employee benefits as a way of ripping-off the tax system for their own enrichment. Yes, there are some well-worn anecdotes about that kind of horror story...but we hope that your committee will remind your colleagues in Congress and the authorities in the White House, Treasury, and IRS that the vast majority of small businessmen offer employee benefits as a sincere service for the well-being of their employees. (2) Tax policy for employee benefits is usually written with the conditions of big business in mind. Small employers cannot afford "anti-selection", higher costs, and the unbelievable red tape which the "simplification" proposals would involve.

Therefore, Mr. Chairman, it is very fair to say that small business is a persecuted second-class citizen when it comes to tax proposals relating to employee benefits. That is bad tax policy, bad employment policy, and bad national policy.

Small business is not the only loser. This prejudice and short-sightedness also could cost Uncle Sam many millions of dollars. A strong privately-paid voluntary employee benefit system (including the majority of Americans who are covered by small business) keeps a large percentage of those workers, dependents, and retirees from collecting government-paid benefits, such as veterans and military health care, Social Security, Medicaid, Medicare, state & local welfare benefits, etcetera. If all of those government benefit plans are already facing financial strain...imagine what our national deficit would be if millions more Americans had to depend on those tax-supported services! Therefore, it is financial lunacy for Uncle Sam to in any way threaten the private employee benefits system...which is such a profitable deal for the government. For the relatively small revenue loss from the tax deductibility of employee benefits, Uncle Sam knows that over 162 million Americans have the benefits they need.

Robert B. Basenke, President — Swanke, Inc., Minneapolis, MN
John Timmer, Vice President — Employee Services, Inc., Sioux Falls, S.D.
W. Ashley Harden, Secretary/Treasurer — Harden & Company, Walnut Creek, CA
James M. Dawson, Immed. Past President — James M. Dawson Associates, Manchester, NH
T.J. Chapman — Bonn Chapman, Ltd., Austin, TX

William C. Earhart — William C. Earhart Co., Portland, OR
Robert C. Gerald — Group Services Administrators, Jersey City, NJ
Ted B. Hale, Jr. — Self Retention Systems, Fairlawn, NJ
Russell R. Naylor — Comprehensive Benefits, Newtown Square, PA
Frederick D. Hunt, Jr. — Executive Director

Past Presidents Council: Robert E. Kelly • Steven L. Shannon • Charles B. Jackson • Glen R. Staughton • W. Richard Perkins

During the discussion of taxation of health benefits, government sources seem to come up with new and drastically different revenue-loss estimates almost every day...and the estimates have an uncanny way of supporting the taxation idea of that person. However, taking the wildest ranges of government revenue estimates, it is clear that the tax exemption for employee health benefits costs only $150 - $1200 per year per American. No government program can even approach that kind of financial efficiency. Why is it so cheap? Because the businesses and workers voluntarily pay the rest...and because employers (especially small business) demand cost-efficiency in their benefits administration. SPBA knows... our members are the leaders in helping small businesses pinch those benefit pennies.

There have been two types of formal benefits taxation proposals:

(1) A "cap" on the amount of tax-free health benefits. Treasury I proposed to tax any "premium" which exceeded $70 for individuals and $175 for family coverage per month. Senator Durenberger has recently proposed S 1211, which would put a "cap" at $100 per month for individual worker coverage, and $250 for families.

This "cap" policy has many problems:

- Employees in more expensive health areas, such as Chicago and other big cities, would be unfairly hit due to no fault of their own or their employer's.

- The amounts may seem generous, especially those of Senator Durenberger. However, remember that the Congress is also being asked every year to shift more and more of the government's benefits cost responsibilities onto the private plans. Where do you think all of those millions upon millions of "savings" in Medicare, Medicaid, veterans health benefits, military medical costs, and Social Security will be made up? You in Congress usually shift the costs directly to employers. Thus, the employer's cost of health care will continue to rise dramatically as long as we have to pay for Uncle Sam's "savings".

- Small employers will especially be crippled by what is known in insurance parlance as "anti-selection". What that means is that the younger and healthier employees will say that since they are suddenly forced to pay tax on health benefits, they would rather take the cash and buy a stereo or car, so they leave the plan. That means that the average age and health of the insured group is worse, so the premium rises dramatically. That encourages the next layer of younger and healthier employees to bail out of the plan. Within a very few years, only the oldest and critically ill employees are still in the plan. The employer might justifiably cancel all coverage at that point. Not only would the costs of the plan be prohibitive...but the policy would no longer be serving its generous intent of offering coverage to virtually all employees.

Ironically, even if the employer did not cancel the plan, the IRS might do so. With any significant degree of "anti-selection", the plan would soon be found to be "discriminatory" because the higher income workers would tend to be the last to leave the plan. Note that Treasury II has an entire section on "discrimination" in employee benefits. With a small employer, even one or two people leaving a plan can trigger "discrimination" and thus cancellation of the plan.

The result: No plan...and those employees must now either pay prohibitively high rates for individual insurance (which is probably not even avail-

able to the older or sicker worker). Or...more probably, the workers formerly covered by the private plan rely on one or more of the public welfare plans (thus costing tax dollars).

• Last, but certainly not least, especially small employers will be inundated with a host of complex new taxes and forms and reporting. This is especially true of the huge number of small firms who have moved to the very cost-efficient self-insurance mode of funding. In self-funding, there is no pre-determined "premium" as there is in an old-fashioned insurance policy. The small business gets to use that cash flow (instead of the insurance company using the businessman's cash) until the money is actually needed. Thus, there is no clear known "premium" value. So, for the over 40% of all American workers who have some form of self-funding...this would be a red tape nightmare.

Let me point out that when we say "small business", we are not only talking about the traditional perception of the corner drug store. A significant proportion of the estimated 30% of the workforce who are members of unions are actually employees of small business. Thus, you will find that even the largest multi-employer union/management employee benefit plans are actually made up of small shops such as butchers, building contractors, etcetera. These union/management small employer benefit plans face even more horrendous red tape and expense to obey Treasury I or Treasury II proposals.

(2) The health tax "floor" is the second taxation concept which has been formally proposed, appeared for the first time in Treasury II. It would tax all Americans on the first $10 value for individual health cost coverage and $25 for family. That sounds appealing at first. However, it has some fatal philosophical and practical drawbacks:

• It makes the President and the Congress liars. We have been told for years that the only reason for taxing employee benefits would be to control the costs of health care. We thought that logic was perverted and incorrect, but we assumed that the President and Congressmen were sincere. The proposal to tax the "floor" of every worker's health benefits does nothing to hinder higher health costs. In fact, it virtually encourages higher costs. Thus, the business person realizes that his faith in the government's high-sounding rhetoric of cost-containment was a lie. That lie is compounded when one considers that the President and so many members of Congress so ardently promised no new taxes. The "floor" tax of employee benefits (and the "cap") are both undeniably new taxes with the sole aim of grabbing revenue.

• Taxing the "floor" still buries especially the businessperson in red tape and administrative busywork which will definitely cause many employers to just give up and cancel coverage for their employees.

Because it is a new tax, the "floor" would add substantially to the employer's costs as well as the new tax on employees individually. Since the new "floor" tax (and the "cap") are considered regular taxable income to the employee, the businessperson is hit with new added Social Security, Workers' Comp, Unemployment Comp, pension, and the various other employer expenses based on a percentage of taxable income. Meanwhile, the employee also faces extra Social Security and state/local tax on the added amount. Again...especially for the small business, it is more expense and more red tape.

There have been a few other ideas whispered, but never offically proposed. Lest they pop up during the heat of a floor amendment or late night

Conference Committee session, let me discuss them now briefly:

- To eliminate the business expense deductibility of employer-paid health care coverage by the employer (taxing the employer instead of the employee). That is virtually guaranteed to immediately terminate employer-provided benefits (especially in small businesses).

- To totally tax the premium value of employee benefits to the worker, instead of just a "cap" or "floor".

These two may sound ludicrous right now. But remember, doesn't Treasury II propose total elimination of the equally sacrosanct state/local tax deduction? Also, if the final tax reform legislation does not include some big revenue-raisers, such as state/local taxes...there will be a feverish search for anything to gain that revenue elsewhere. The employee benefits profession and business community have learned from hard experience that this is the kind of last-minute scramble which does the private enterprise benefits system the most harm. It is quick, not thought-out, and based on trumped-up revenue estimates. It usually backfires!

Thus, Mr. Chairman, we urge you to reject these kinds of acts of desperation now. We sincerely commend your committee for taking the time and thought to consider the damage that would be done to America's larges employment base and the most cost-efficient system of helping Americans care for each others' health and security. SPBA, its members across the country, and the SPBA clients who represent over 1/3 of all U.S. workers, are eager and ready to help you and your colleagues to find logical and workable solutions.

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June 5, 1985

Tracy Crowley
Hearing Court
SENATE SMALL BUSINESS COMMITTEE
428A Senate Russell Bldg.
Washington, D. C. 20510

Dear Mrs. Crowley:

I am writing to you regarding the hearing on June 10th in Chicago that deals with the taxation of employee benefit plans. I would appreciate my letter being submitted as testimony for that hearing. The taxation of employee benefit plans has been bandied about for the last couple years. The administration first proposed a tax cap as a vehicle that would implement cost containment and in short, solve all the problems of the world. After 30 some years in the business, I look at the tax cap as a revenue raising vehicle. The value as a cost containment concept, is absolutely minimal.

The true colors of the tax cap has surfaced. The attempt to put a tax on first dollar benefits is a revenue raising concept. I strongly suspected that the tax cap was nothing more than a revenue raising concept.

We constantly hear from the Washington scene, criticism of the various actions across the country each protecting their own domain and screaming "don't close the loop-holes in my industry - don't tax me". The DEFRA Act closes many, many loop-holes that affect all of us. In substance, the DEFRA concept is perfectly reasonable.

The tax on basic employee benefits is not a closing of loop-holes. It is in fact, a new tax. It has to be a wonderful vehicle for the Congress. The opportunity to raise the tax level on employee benefits is quite simple. Probably could even be done with regulations. In a land where we have taxes on everything we do to the extent that people don't even know the taxes they pay, this is just an addition. I question the integrity of the administration when the campaign issues were "no tax increase". Granted this is not a tax increase - this is a new tax.

The shining armor of Regan, Kempf, Stockman, etc. is getting a little tarnished.

By the time Internal Revenue finishes the regulation writing, this is going to cost the average small businessman one hell of a lot of additional bookkeeping. You did it to us on the FICA on disability income, the FUCA on disability income and as Barry Wold, a regulation writer from Internal Revenue jokingly says this will cause no additional work. Let me tell you, it does cause additional work. The tax on employee benefits is going to cause additional work. I'm perfectly willing to bite the bullet on those revenue raising endeavors on the part of DEFRA. The closing of loop-holes is reasonable.

I don't want to be identified as one of those that says tax somebody else not me. I do want to be identified as complaining bitterly to Washington continually compounding the administrative details that are foisted on the small business community.

Sincerely,

R. B. Swanke
Secretary-Treasurer

RBS/mps
cc: Fred Hunt